PREFATORY NOTE

These transcripts have been produced from the original raw transcripts in the FOMC Secretariat's files. The Secretariat has lightly edited the originals to facilitate the reader's understanding. Where one or more words were missed or garbled in the transcription, the notation "unintelligible" has been inserted. In some instances, words have been added in brackets to complete a speaker's thought or to correct an obvious transcription error or misstatement.

Errors undoubtedly remain. The raw transcripts were not fully edited for accuracy at the time they were produced because they were intended only as an aid to the Secretariat in preparing the records of the Committee's policy actions. The edited transcripts have not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Meeting of the Federal Open Market Committee

December 20-21, 1982

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Monday, December 20, 1982, at 3:00 p.m. and continuing on Tuesday, December 21, 1982, at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Solomon, Vice Chairman
Mr. Balles
Mr. Black
Mr. Ford
Mr. Gramley
Mrs. Horn
Mr. Martin
Mr. Partee
Mr. Rice
Mrs. Teeters
Mr. Wallich

Messrs. Guffey, Keehn, Morris, and Roos, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, Boykin, and Corrigan, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis, respectively

Mr. Axilrod, Staff Director
Mr. Altmann, Secretary
Mr. Bernard, Assistant Secretary
Mrs. Steele,1/ Deputy Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Oltman,1/ Deputy General Counsel
Mr. Kichline, Economist

Messrs. Ettin,1/ J. Davis,1/ R. Davis,1/ Keran,1/ Koch,1/ Prell,1/ Siegman,1/ Truman, and Zeisel,1/ Associate Economists

1/ Left the meeting prior to discussion and adoption of domestic policy directive.

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors
Mr. Slifman, Associate Director, Division of Research and Statistics, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Messrs. Beebe, Dewald, Lang, Rolnick, Scheld, and Ms. Tschinkel, Senior Vice Presidents, Federal Reserve Banks of San Francisco, St. Louis, Philadelphia, Minneapolis, Chicago, and Atlanta, respectively

Messrs. Goodfriend, McNees, and O'Driscoll, Vice Presidents, Federal Reserve Banks of Richmond, Boston, and Dallas, respectively

Ms. Meulendyke, Manager, Open Market Operations, Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting of December 20-21, 1982

December 20--Afternoon Session

CHAIRMAN VOLCKER. I thought we might change the order [of the agenda] a bit today since the short run blends into the long run and the long-run view may affect the short-run view. I thought we would first approve the minutes anyway.

SPEAKER(?). So moved.

SPEAKER(?). Seconded.

CHAIRMAN VOLCKER. Without any objection, we'll approve the minutes. I thought we might have the business description first, if Mr. Kichline is ready, and have whatever discussion you want of the business [situation and outlook]. Then we will go to Mr. Axilrod who will talk about the short-run problem but in the context of the longer-run problem. We will then discuss the longer-run problem and come back to the specifics of what we want to do, which would be tomorrow, if that is agreeable. I don't know if it's more logical or not but for some reason it seemed to me it might be more logical. We could wait for [the Managers' reports] tomorrow or we could do that now. Why don't we--

MR. STERNLIGHT. I can do mine now, Mr. Chairman.

CHAIRMAN VOLCKER. We can turn to Mr. Sternlight now. We can't hear from Mr. Cross now because I asked him to go to a meeting in New York this afternoon. He will be here tomorrow morning and we can discuss the international aspects then. Why don't you go ahead and get your report out of the way, which I think is also background.

MR. STERNLIGHT. Okay, fine. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Any questions or comments?

MR. BOEHNE. I have a question. Would you comment some more on the backup in long-term rates following the discount rate drop a week ago? Would you attribute that to technical reasons or is there anything there that might be a harbinger of a change in expectations with regard to Fed policy and inflation?

MR. STERNLIGHT. Well, I don't know if I would attribute the backup to the discount rate. The discount rate reduction certainly didn't have the impact of earlier reductions in reducing longer-term rates; one heard the comment from a few people that maybe the recent money growth would lead to a reemergence of inflation at some point down the road, so that investors were less inclined to continue the interest they had had in the longer-term market. I would regard this last discount rate move as having been about neutral for the longer market. The fact that rates have backed up in the longer end I would attribute more to the supply [of new issues] coming in the longer-term sector. Treasury supplies have been quite heavy and the corporate supply and tax exempt supply are also on the sizable side.

MR. RICE. Peter, did you notice anything in the financial markets or other developments that would explain the relatively high volume of demand for excess reserves?

MR. STERNLIGHT. Well, during the recent period, some of it was around the Thanksgiving weekend. There is often a lot of churning then. This tends to be a season of the year when we have high excess reserves; but as I indicated, the actuals exceeded even the above-normal allowance that we had made for it. I'm just surmising now, but the flows associated with the new accounts could explain some of it. Also the period around the mid-December dividend and tax dates is often a time of greater demand for excess reserves. Nothing else comes immediately to mind as a special factor.

CHAIRMAN VOLCKER. No other questions or observations? We have to ratify [the transactions]. Do I have a motion?

SPEAKER(?). So moved.

SPEAKER(?). Seconded.

CHAIRMAN VOLCKER. Without objection. We have [the Manager's] request to increase the [intermeeting] limit.

MR. FORD. May I ask what the limit is now?

MR. STERNLIGHT. The intermeeting leeway is $3 billion.

MS. TEETERS. And you're asking for $4 billion?

MR. STERNLIGHT. I'm asking for $4 billion.

CHAIRMAN VOLCKER. He wants a lot of leeway to be restrictive, as I understand it.

MR. STERNLIGHT. To absorb the reserves.

MR. BOEHNE. I'll go for this provided that he doesn't want to buy coupons directly from the Treasury next time!

CHAIRMAN VOLCKER. Do we have a motion on [the leeway]?

SPEAKER(?). So moved.

SPEAKER(?). Seconded.

CHAIRMAN VOLCKER. Without objection, you get another bit of leeway. Now we will turn to Mr. Kichline.

MR. KICHLINE. [Statement--see Appendix.] I might note that tomorrow morning we expect to receive the CPI figures for November as well as some revised GNP data for the third quarter.

MS. TEETERS. Will you have the flash tomorrow morning, Jim?

MR. KICHLINE. Yes.

CHAIRMAN VOLCKER. How close are we, if at all, to the end of this adjustment to natural gas prices--these new contracts that are very high?

MR. KICHLINE. Under the current legislation, by 1985 I believe only something like 60 percent will have been completed--that is, freed to the market. So there is another 40 percent under the Natural Gas Pricing Policy Act of 1978 that would still be under [price] control. It is our view that if we have oil prices at about the level they are now and no additional congressional action, we will be facing very large double-digit increases for the next 3, 4, or 5 years at least.

CHAIRMAN VOLCKER. Even at the present market price for gas? The present gas prices, as I understand it, at the margin, are way below those in these contracts. If a buyer just went into the market today and bought some gas, the price would be much less than some of the high contract prices that they entered into a year or two ago.

MR. KICHLINE. That's right. Those are the contracts, though, that were adopted in a mood of panic by a number of gas transmission lines who could not service their customers. But the prices of much of the gas under control, the old gas, are substantially below the BTU equivalents of residual fuel oil. And if we continue this discussion too much longer, I will have exhausted all of my knowledge of that market!

CHAIRMAN VOLCKER. I will cease. Mr. Guffey.

MR. GUFFEY. I would just note that we had a discussion at our board meeting about this very problem, the take and pay contract. I think the [bulk] of that is the take and pay contracts, or at least 10-year contracts that were entered into by the pipelines or other suppliers. The interesting part is the fact that take or pay means that they pay if they don't take but they also have that gas available to them sometime in the future, so they're putting it on their balance sheet. In a sense, there should be a time when these take and pays are either altered or they just run out. There is a supply of gas that is already paid for in these pipelines that sometime out in the 1985-86 period will perhaps bring gas prices to a much lower level than is now being paid for gas.

CHAIRMAN VOLCKER. After that clarification, I--

MR. GUFFEY. Well, they are just building up an asset, that's all. In other words, if they don't take it, they have to pay for it but it comes to them later.

CHAIRMAN VOLCKER. I was just curious about what that profile of prices was.

VICE CHAIRMAN SOLOMON. There is some movement in the Congress to try to modify those contracts because of the anomalous situation, isn't there?

CHAIRMAN VOLCKER. I don't want to divert this whole discussion to gas. Who has comments about the business scene? Who senses a recovery? Hearing nobody, who has a comment?

MR. BOEHNE. [I sense] just a little [recovery] in the nonmanufacturing area. The housing people, of course, are happier and the retail people seem to be a little happier. In general, most areas outside manufacturing seem to me to show a glimmer of a bit better feeling. Salesmen are not coming back with a lot of firm orders but are feeling better that there may be some orders coming up. But in manufacturing, things are still dead; they're more than dead; they are deteriorating. Some of these people consider themselves to be in lagging industries anyway, but I think compared to a month ago I sense just a glimmer, a flicker, of a little better feeling.

MR. BOYKIN. In our District, of course, things are still weak but residential construction, which has already been mentioned, is coming on very strong. The National Association of Home Builders is looking for Houston to lead the nation and Dallas to be second in 1983 in residential construction. Office construction is still slow but other nonresidential seems to be picking up a little and so are retail, the state, and other businesses. The energy sector, which was also mentioned, is reviving somewhat. The rig count is up in November and it does appear to be up a little more than we would expect on a seasonal basis. The unemployment rate was down in Texas in November; we don't have a lot of confidence in the state figures but at least it's in the right direction. The weak areas are the ones that we would expect: manufacturing, particularly the durable goods sector, and the farm sector, which still has its problems. Loan demand is weak, with a less-than-seasonal rise in November; retail sales for the District as a whole are not overly promising, although sales in Dallas, Houston, and Austin are looking pretty good.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. Our District experienced significant strength in new home sales in November, and automobile sales seem to be improving. Retail sales are up on average 6 to 6-1/2 percent. But as Ed Boehne mentioned, the heavy equipment industries are in bad shape.

CHAIRMAN VOLCKER. Those are the optimistic comments. Now we hear from--

MR. MORRIS. I think all one can have now is a very muted optimism. I was at a meeting with the head of the National Association of Home Builders, [unintelligible] and Mike Sumicrast. I was quite amazed how optimistic the home builders were.

CHAIRMAN VOLCKER. They're very optimistic. I don't know what they're smoking!

MR. MORRIS. I checked this out with the local real estate people around Boston and they have seen quite a turn in the movement of residential real estate. But, tomorrow, don't we also get new orders for durable goods?

MR. KICHLINE. Yes, tomorrow afternoon.

MR. MORRIS. You can't get that in the morning?

MR. KICHLINE. I can't.

MR. MORRIS. That's going to be a very key number. I think we have to see a turnaround in new orders or this muted optimism we've seen so far is not going to stay with us.

MR. BOEHNE. It's all relative, you know. I don't get the feeling that people are super optimistic. It's just that most people have been so pessimistic that even if they don't say much at all, you take it that things may be better.

MS. TEETERS. Don't forget, the increase in housing starts is all the seasonal adjustment factor. The seasonally unadjusted number is flat. And any increase in housing starts that we get from now to March that is seasonally adjusted isn't going to be very many real houses.

MR. BALLES. Absolutely. And even worse, Nancy, though I don't have the exact numbers in mind, the proportion that is going into apartments is now pretty big in comparison with single-family homes, and therefore builders are using a lot less lumber and cement and so forth. So I think one really has to disaggregate those figures to understand what is going on. I agree with you that [the housing situation] is not really as optimistic as it appears.

MR. MORRIS. But at least there is some evidence that at the present level of mortgage rates it is possible to move some housing off the market, which hasn't been true for some time.

MR. MARTIN. It's possible also to refinance some of the balloon payment arrangements that have been made around the country.

CHAIRMAN VOLCKER. Who does not see this little--firming is maybe too strong a word--[uptick]?

MR. BOEHNE. A little twinkle of a star is about what it is.

CHAIRMAN VOLCKER. Apart from the great Middle West, Mr. Keehn.

MR. KEEHN. If you're looking for bad news--

CHAIRMAN VOLCKER. You are not part of the program.

MR. KEEHN. I would suggest that there has been a deterioration, whereas at the last meeting I had a tinge of feeling that maybe things were getting better. The housing side may be better, but I think Nancy Teeters is absolutely right that we have a seasonal adjustment factor that complicates that scene. The auto side certainly is better. In retail sales, the optimism that was evident as people were getting ready for the Christmas season has begun to deteriorate. People on the retail sales side that I talked with are clearly disappointed by the way they see Christmas shaping up. On the industrial side, capital goods are declining further. There is absolutely no evidence of a turnaround among the people I talk with, and the pessimism is getting to be very, very pervasive. I think some of these people are beginning to run out of gas. They just are terribly, terribly discouraged.

CHAIRMAN VOLCKER. Is there anybody who has a good report on Christmas sales?

VICE CHAIRMAN SOLOMON. Yes, I have a reasonable one. The chains tell us that their sales are doing fairly well in the eastern region, with particular strength in apparel, cosmetics, and consumer electronics. But they say that their sales in other parts of the country are not doing as well. For some reason the East seems to be doing fairly well on retail sales.

MR. PARTEE. Remember, there's an extra shopping day, too. That makes a lot of difference at the daily rate they're going.

VICE CHAIRMAN SOLOMON. The head of one nationwide chain told me, and I found it very interesting, that the reason they were doing better than a lot of their competitors was that they had not pared inventories as much and, therefore, they had more stock for consumers to choose from.

MR. GRAMLEY. I would add my voice to those who are concerned about whether or not the recovery is going to materialize. The Redbook this time, although noting elements of optimism--the twinkle, if you will, Ed--commented repeatedly about the manufacturing sector slipping further into recession and attitudes becoming more and more pessimistic. I think we're dealing here with a combination of a big inventory overhang, particularly in durables, declining business fixed investment, and very, very sick export markets. What I worry about most is the possibility that the efforts to improve productivity, which have been going on in full force since midyear, will continue to erode employment and earned incomes. So this little revival of consumer spending that we feel over Christmas may prove to be very, very short lived. If I were to put down numbers--if I were in Mr. Kichline's position and thank heaven I no longer have to make my living that way--I might come up with some very similar numbers. But my worries all focus on the possibility that in fact we'll see another disappointment.

CHAIRMAN VOLCKER. Any other comments on the business scene? I don't hear enormous encouragement around the table.

MR. BALLES. Well, in the far West, things are continuing to slide downhill. I can tell you why if you want to know, but I'd just as soon not. It's the same old story: Forest products are in a bad slump, and electronics and aerospace, which are two of our strong growth industries over the long term, are in a big slump. Boeing's sales are at the lowest level in twenty years. It's one [industry] after another like that, and we see no signs of a turnaround as yet in our economy.

MS. TEETERS. Boeing must be getting a lot of defense business, aren't they?

MR. BALLES. They are getting some, but it is in long lead time items, and it's not nearly enough to counteract the enormous number of cancellations, on planes particularly.

MR. FORD. We can verify that at Lockheed in Georgia. We had this political battle on getting the C5A versus some 747, which is made out in Mr. Balles' District and we won it. So, I asked the head of Lockheed Georgia, Mr. Ormsby: "When do we get these thousands of jobs due to our big political victory?" He said it will start about two years from now. The lead times are quite awesome, in terms of gearing up an assembly line to produce a big plane like that.

MR. PARTEE. How are things down in the Sun Belt? Do you sense some pickup?

MR. FORD. Well, I'm on the side of the twinklers, without any doubt, although the picture is mixed, especially with the things that Lyle mentioned going on. In our heavy industry belt over toward Alabama up to the lower end of the Midwest, we are getting clobbered. We're still losing jobs; and parebacks and efficiency-type cuts are going on very heavily in some industries. But we are getting the same signs of the nation's recovery, a little stronger I would say in some sectors, mainly in housing. For instance, we are getting a lot of optimism and a pickup in permits in a number of major urban markets around our area. One of my directors quipped the other day that he actually saw a lumber truck going down the road, but he didn't think it was heading for the bankruptcy court. So, we are starting to see a housing pickup. The two big air carriers that operate in our area, Delta and Eastern, both reported advance bookings up pretty sharply for travelling to our area. So, there are some signs of light. I wouldn't bet my life savings on there being a boom just now. We have the same mix of concerns that others have. Residential construction is good, but other construction looks weak.

MR. CORRIGAN. In the housing sector I do hear from bankers and thrift people that there's a lot in the pipeline that hasn't even shown up in mortgage commitment figures, much less in permits or starts. So, notwithstanding the seasonal problem, I think there is some momentum there.

MR. FORD. We've had a lot of new mortgage money flow into our "price riot" institutions. Over a billion dollars flowed in two days into the institutions in Atlanta that did the 21 and 22 percent pricing; they have to lay it off somewhere and we're hoping that some of it will go into housing.

MR. PARTEE. They are going to buy mortgages with that hot money, eh?

MR. FORD. The S&Ls that did it are really talking about going out--you might know more about it personally. The ones that did it are very euphoric; they got a lot of money.

MS. TEETERS. They guarantee that rate for how long, Bill?

MR. FORD. For 30 days, until January 13. They're going to make 30-year mortgages with 30-day money, I guess!

CHAIRMAN VOLCKER. Well, you have a happy background, Mr. Axilrod, to tell us how to deal with it.

MR. AXILROD. Well, Mr. Chairman, the Committee's decision today or tomorrow for operating purposes--the one that pertains to the directive between now and the next meeting--also, of course, relates to the fundamental problem before the Committee about how to target 1983 as a whole, a decision that has to be made in February. So these two things are somewhat related at the moment and I'll try to bring the two together if I can.

In the alternatives that we presented in the Bluebook we have keyed on the broader aggregates, following what the Committee has done in the last couple of months, of course, though we've given enough data on M1 should the Committee wish to go in that direction. The large memo [Secretary's note: A copy of this memorandum, "Options for Intermediate Targets and Implications for Operating Procedures of Deposit Rate Deruglation," has been placed in the Committtee's files] that was prepared by Messrs. Davis, Judd, Lindsey, and myself and sent to you suggests that in this transitional period that we're entering--beginning on December 14 with the availability of the MMDA accounts, and continuing to January 4th or 5th with the availability of Super NOW accounts--the transitional difficulties with M1 would tend to make it very difficult to present in February a target for M1 for the year. And thus by definition we believe that it would be difficult to target on M1 now going into the first quarter, as the target that is set today or tomorrow will pertain to the first quarter. We came to that view, recognizing that it was quite possible that we would luck into offsetting shifts and we'd have a low number [for M1 growth], but we couldn't really say with any definiteness that that would occur. On the one hand, as you probably read in the DIDC [report], the MMDA accounts could tend to dominate, and that would pull money out of M1 and lower the growth of M1; on the other hand, the NOW accounts may tend to dominate, and that may bring money into M1. I don't see how anyone can decide in advance exactly what is going to happen. We have done our best in the Bluebook appendix to make a variety of estimates and, as you see, we came to a wide range of estimates, particularly with regard to M1. So without discounting the possibility that we could get a moderate M1 performance from offsetting shifts, we felt that one couldn't rely on that in advance nor could one with any definiteness say exactly how the shifts were going to go, and thus it might be better to bypass M1 at least for a transition period.

Now, having said that, the group as a whole felt--and I would say we felt it more strongly as we talked together--that M1 was really the best that might be left if you looked at everything. So we were left with the great "hope" that when the transition is over, whenever that might be--and it may be midyear or conceivably earlier if everything goes rapidly--that it would again be possible to target on M1, but we didn't think it would be the same animal. So, even if it became possible to target on M1 when all the shifts are over, we might be left with an animal that has a very different composition if NOW accounts dominate; it may have a large mix of investment-type funds and transactions funds, something like a money market fund. And, therefore, it would behave differently than the old M1, and it would take some time to analyze and evaluate its behavioral characteristics. That's no more than saying, of course, that the new M1 could be like the M2 that we now have, but it would be somewhat better in the sense that it would at least have more transactions components in it than M2, which has the transactions component and a much wider variety of assets. So, for the reasons given in the memo that I don't need to repeat, we tended to hope that M1 would come back and be a somewhat viable target around midyear, maybe not in the full force it has had before but at least viable enough that the Committee would not feel the need to ignore it within a broad range.

M2, of course, also has its transitional problems. I think we went to some pains to point those out; and we tried to make estimates in the Bluebook about how much M2 might be affected by the shifts. We think that pretty clearly we are not likely to see shifts out of M2 into market instruments. So the shifts would be from market instruments into M2, perhaps even from large CDs or from Eurodollar liabilities into M2, through these money market deposit accounts mainly. And we would think, if the behavior of NOW accounts is any guide, just in terms of the speed of transition, that much of it would be finished over a 3- to 4-month period. We have not estimated quite as fast a transition as occurred with NOW accounts largely because a lot of the money that would go into these other accounts is in market instruments, which bear a relatively high interest rate, so in a sense there's [no] need to rush. But our estimate, with a wide range of error around it, was that in the first quarter perhaps something like 3 percentage points at an annual rate worth of funds might be shifted; and that would raise M2 for the year something like 1 to 1-1/2 percentage points [because] of shifts. We think the effects on M3 would be a little less because of offsets. That is, if banks get money through MMDA accounts they may issue fewer large CDs, not to mention shifts directly from large CDs into MMDAs. So, we don't believe M3 will be as much affected as M2.

One of the problems, if the Committee does wish to continue targeting on M2 and M3 for a longer period--let us say, 3 to 6 months or whatever--is that, as the Committee knows, we don't get as much automatic response because of the reserve requirements. The average reserve requirement is much lower on M2 and M3 than it is on M1. It's on an order of magnitude of 2 percent as compared with 10 percent; it's 5 times lower. And since M2 doesn't vary proportionately as much as M1, we just don't tend to get as large an automatic adjustment. Now, this would lead to a greater need for the kinds of judgmental adjustments that we have been making with regard to M1. We normally make them on the up side, when the total reserves demanded are $200 million or so in excess of the total reserve path; we have more often than not lowered the nonborrowed reserve path in order to provide more restraint. And with regard to M2 and M3, it's possible that if the Committee wishes to retain roughly the same sort of handle, such a judgment might have to be made a little sooner because the automatic response simply is not quite as great. I ought to point out something that I think was in the memo but maybe not as clearly as it should have been: If you're targeting on M2, you don't have to control it any more closely than you have controlled M1 in the past to get a better GNP performance. In some sense it has that advantage because interest rates are a lot more sensitive to efforts to control M2; you have to push the interest rates to control M2 because it has very little interest elasticity. So, if you're off on M2 by roughly the same [percentage] amount as you're off on M1, you might have more interest rate movement and, therefore, more impact on GNP. So, while it's more difficult to control, if you miss it but you're trying to control it, you may get a somewhat better GNP performance. On the other hand, this has risks that are important because if you happen to have specified the wrong M2 target or the wrong M3 target--if the demand for M2 relative to whatever GNP is satisfactory to you has shifted and you're making a big effort to control this broad M with little interest elasticity, or even a narrow M with little interest elasticity--then the penalty on the economy will be much greater because interest rates will have moved very rapidly and the economy will be behaving very unsatisfactorily in the situation when the target is wrong. That means, of course, that you may want to think somewhat cautiously about letting the money market adjust until you're fairly certain that the movement in the broad money supply is truly reflecting credit demands and GNP behavior and does not simply mean that the public's behavior has shifted and you have chosen the wrong target. So, those are the kinds of risks involved when we move toward broader monetary aggregates and even when we have an M1 that has less interest elasticity.

Now, we examined even broader aggregates, which got us to the vexing question of credit. I don't have much to add to the very carefully worded concluding section on credit in Part I [of the memo] where we as a group thought that credit would provide a reasonable context for judging financial flows but felt that as a short-run guide to monetary policy it had its problems, at least at the present stage of our knowledge, given the statistical problems we think there are and the vexing questions of cause and effect that are also involved. Certainly, these kinds of questions also relate to the broader monetary aggregates, so it is a matter of degree as you go out [toward broader measures of money and credit] as to where you think the effect on GNP [dominates] or where you think there is some causal connection between what you do to the aggregates and GNP. There are controllability problems with regard to total credit that are simply the same kinds of controllability problems we have with M2--possibly a little worse--and I've mentioned them with regard to M2. The question is: Can it be controlled independently of controlling GNP? Or when you go to total credit, are you in fact simply saying you are going directly to GNP, so the control mechanism there is not just simply a reserve base to money kind of control mechanism.

We also discussed the narrower aggregates, the monetary base and the nonborrowed base. As a group we felt that the monetary base basically should be viewed as derived from the demand for the various other aggregates, so that it did not really save the Committee the difficult task of making judgments about the more standard aggregates. It might disguise that problem a little, but in the end when you come down to making a decision, you really have to judge whether you are happy or not when M1 is coming in strong and the monetary base is on target. So we felt that it was really a derived demand and in that sense did not give it much weight. The nonborrowed base is also in some sense derived from the demand for the other aggregates but at least borrowing is available as a buffer so that it can accommodate shifts between demand deposits and currency; thus we thought there was a little more to be said for the nonborrowed base as a target rather than the monetary base. However, we felt that the nonborrowed base had somewhat less public credibility than either the monetary base or any of the other Ms and we did not in our own thinking put much weight on it as a guide to the Committee. Nevertheless, I would say--and others here can speak for themselves--the more we thought about it, most of us began to see some virtue in it.

Looking to the immediate problem, in the context of providing a directive between now and the next Committee meeting, one might be tempted to take the view that the [shape] of the adjustments to the new accounts will be much clearer by early February when the Committee has to decide on the long-run targets and, therefore, that over the next few weeks in this initial adjustment period the aggregates will provide virtually no basis for guiding policy. Even if they're going to provide a difficult basis in February, the question would be: What basis would they provide between now and February? These uncertainties immediately ahead of us--the unknown range of possible outcomes--seems to us to be greater for M1 than for the broader aggregates, as I've mentioned. However, there are uncertainties with respect to the broader aggregates; the direction of effect seems clear but the magnitude of effect is uncertain. Moreover, partly because of the wide range of assets involved, it is going to be very difficult to measure the magnitudes actually shifted after the fact, although obviously we will attempt to assess them from the behavior of various components of the series [constituting the] aggregates, questions to depository institutions, econometric evidence, and consumer surveys.

Despite all these problems, the suggested directives for Committee consideration in the Bluebook retain the broad aggregates as a guide between now and the next Committee meeting in February. There are number of reasons for that but an important one is to insure that the public understands that the Committee is continuing on the anti-inflationary course set earlier, even while taking steps to stimulate economic recovery. That is particularly important at this time in view of the doubts that seem to be emerging, at least in bond markets, about the Federal Reserve's intentions. I may put slightly more stress on that than Mr. Sternlight put on it. The last discount rate cut was followed immediately by a drop in long-term interest rates and also short-term rates, but the declines in long rates subsequently have been reversed as have the drops in short rates to a degree. In part these reversals might have been the result of unusual mid-December tax period pressures in the money market combined with the coincidence of unusually heavy Treasury and state and local government borrowing demands. Still, many in the market have come to wonder whether in practice, even if not in concept, the aggregates are not being ignored at the expense of stoking inflationary pressures later. In that context it may be something of a tactical problem whether or not the Committee specifies a [monetary growth rate] in the directive that appears relatively high. If some credence is given to the staff's estimate that shifts into M2 in the first quarter will be at an annual rate on the order of 3 percentage points--and I stress that there's a wide range of uncertainty around that--then a relatively large number would probably be needed for M2 to accommodate that shift, as indicated in the three Bluebook alternatives. However, if we are right about the nature of the shifts that will take place, a relatively moderate M3 figure would seem to be attainable. If a high M2 number is stipulated in the directive and if a moderate M3 is not felt to be a sufficient counterweight, the question naturally arises as to whether an indication should not also be given regarding our preliminary thinking about the extent to which that high number is affected by shift distortions. The risk of doing so is that in the weeks ahead the System may then have to provide a specific quantitative shift adjustment factor, a highly conjectural procedure in my opinion under current circumstances. Qualitative-type judgments about the extent and nature of shifts will be necessary in any event but quantification, apart from fairly broad ranges, is likely to stretch the available data beyond its reach.

An alternative approach to the directive would be to provide a relatively low M2 figure and indicate that growth could be high if there were evidence that shifts were distorting M2 by a significant amount. Since the figure initially given should probably accommodate some amount of shifting, I would think that a figure representing M2 growth for the first quarter much lower than 9 or 10 percent may be too far out of touch with possible developments, unless of course the economy and/or the rate of personal saving is much weaker than currently anticipated. If a figure in the 9 to 10 percent range or fractionally lower is inserted initially, it would seem that in practice the Committee might wish to tolerate a reasonable range of growth around it, certainly in the initial weeks of the adjustment period, before any substantial automatic changes in money market conditions occur. This might also be the case for the relatively high figure, though in those circumstances shortfalls might appear more tolerable to the Committee than overshoots. If the Committee goes that route, the initial tilt given to the money market by the Committee assumes more importance than usual in the sense that the odds increase that the tilt will last for several weeks, the next scheduled meeting being 7 weeks from now. With borrowing from the discount window already near frictional levels or implied to be so by the reserve paths, there is only a little, though some, scope for the Committee to ease market conditions, if that's the inclination, without risking losing touch with the market by setting a reserve path that could come to involve virtually no borrowing and thus virtually no anchor for the federal funds rate. On the other hand, the discount rate does remain as an available guide to money market conditions if borrowing is left to fluctuate around or slightly above a clearly frictional level. That probably would put borrowing in a $200 to $300 million range, based on recent experience, although there is a fuzziness about the edges of that range. I apologize for the length of [my comments], Mr. Chairman, but it was an effort to bring the short- and long-run [issues] together.

CHAIRMAN VOLCKER. Well, you made it all crystal clear for everybody, I'm sure of that! I think the most interesting things in this paper are the chart and tables on the last two pages. To sum up, I think that's--

MR. PARTEE. Nothing looks any good!

CHAIRMAN VOLCKER. Right. Every one of them is off the trolley in the past year.

MR. PARTEE. Even credit.

CHAIRMAN VOLCKER. You pay your money and you take your choice. And I think that is a fact of some significance. Maybe people have firmer ideas than I do, but I would not discount entirely having a meeting before February 8-9, if that seems desirable and seems to be a way to make some progress. Let us open up the floor for any general discussion there is at the moment. I assume there will be some.

VICE CHAIRMAN SOLOMON. I have a question, Steve. You have in your monthly pattern an extremely low growth figure for M2 for December, 4-1/2 percent. That seems a little hard to believe, particularly since you are arguing that the [main] influence of the inflows to the new accounts will be to expand M2. How do you get the 4-1/2 percent figure?

MR. AXILROD. Well, M2 has been very weak [this month] and the average level through the first half of December is not inconsistent with that kind of growth rate. We foresee only a small expansion over the rest of the month beyond the fragmentary data we have through the middle of the month. I would say there is some doubt about that; it could come in higher. But I would put the range of estimates between 4-1/2 and 6-1/2 percent. I don't think we're exposed, at least at this point, to a real burst of M2 growth. Two years ago we had a huge drop in M1 components in the last two weeks of the year, which saved the year in 1981. I think that was the year when we had the sharp [December] drop in M1; we don't have that built into this M2 estimate. What we have is virtually no increase in the nontransactions component. You are quite right that the 4-1/2 percent growth is something that might not develop, but it's not inconsistent with the pattern of weakness that has developed in the last couple of weeks when we have been surprised by the weakness.

CHAIRMAN VOLCKER. These problems are related but I think our discussion of general problems might logically precede discussion of the specific problem for the next few weeks.

MR. CORRIGAN. Steve, in the larger paper, and I think in the Bluebook as well, the point is made on several occasions that we are left with a 2 percent average reserve requirement on M2 and 1-1/2 percent or whatever it would be on M3. The inference is that that is the problem. My question is: Is that the problem or is it the definitions [and] elasticities? Suppose we had an aggregate the size of M2 but it was a nice clean M2 like the old M1 or something like that, then wouldn't a 2 percent average reserve requirement be more than adequate?

MR. AXILROD. Well, if it has a lot more interest elasticity one might have to see; if it doesn't, then it's not going to be. But one can go into that problem another way, too. We used the 2 percent, but it's an open question as to what really will happen in the short run. We could do this [in such a way as] to have a massive effect in the short run. If we assumed that in the short run there was nothing we could do about money market funds and all that and that all we could affect was the demand deposits subject to reserve requirements, then we could construct the path in such a way that when money funds went up we would force all this money out of demand deposits. Then the reserve requirement we are dealing with is 10 percent and we wouldn't be trying to affect everything proportionately because we wouldn't believe that's what would happen in the short run. If we did that, of course, we would get massive interest rate effects in an effort to control it. That's what led us to suggest a shadow of 3 percent or something in between.

MR. CORRIGAN. I guess I understand. I certainly agree with what you are saying in terms of the kinds of results we could face but I have some problems with the notion, even as you elaborated it, that the nub of the problem is that we have a 2 percent reserve requirement. We would have the kinds of problems you're talking about if we had a 5 percent reserve requirement.

MR. AXILROD. Well, yes, I suppose. I haven't made the calculation. I suppose there is some reserve requirement. If it were 100 percent, we would have no problem because we would force whatever interest rate adjustments were required, and they would be massive. So, at some point, we would find ourselves with a reserve requirement, given the interest elasticity, that would make us feel comfortable. I'm not sure exactly where it is.

MR. CORRIGAN. The reason I asked the question is because you hold out the hope that when all this transition is through we may be able to go back to a happy world of M1. I have some trouble, given a reasonable guess as to what the components of M1 will be and what it is going to look like, seeing how even by June or July we are going to be able to operate in that happy little world.

MR. AXILROD. I would say, President Corrigan, that we did hold out the hope, but mostly we didn't really want to be in a position of prejudging it at this particular time. I guess we mostly felt that something was needed between the Committee and GNP. If we don't have some aggregate--I don't see much else to choose from, the others may speak for themselves--between the Committee and GNP, then in that case you might just as well start controlling interest rates depending on your best assessment of what is going to happen to GNP. That is what we were grappling with.

CHAIRMAN VOLCKER. Was the happy little Canadian experience mentioned at this meeting or mentioned someplace today? They just abandoned M1. They had this beautiful record of the past 5 years of M1 steadily going down and inflation steadily going up.

MS. TEETERS. Steve, with all the nonreserveable components that are already in M2, aren't you going to have a rather major problem trying to estimate what the multipliers are? For any given dollar of reserves we really don't know how much inventory it creates.

MR. AXILROD. Yes, that's true. There can be a lot more shifting within M2, but we get a flow of data continuously and we can adjust for that. If money market funds were strong and demand deposits were weak but M2 was on course, we would simply reduce the reserves for that purpose. Now, with lagged reserve accounting, we don't have any problem with that. When we get the contemporaneous reserve accounting, then we're likely to be faced with a more difficult problem because it could happen in a current week that money market funds are strong and demand deposits are weak. If we put in the reserves as if it were going to be vice versa, interest rates would drop. So, with contemporaneous reserve accounting there is more difficulty with multiplier adjustments. They don't come with certainty after the fact. But in principle, that is what we would be doing.

MS. TEETERS. But then wouldn't you have trouble drawing a reserve path if you weren't quite sure where it is going to go?

MR. AXILROD. Yes, but that's in the nature of reserve paths. That's right. That's the problem with anything less than 100 percent reserve requirements and targeting on anything that has aggregates in it that aren't subject to reserves. The controllability to a degree is reduced. That's quite right.

MR. PARTEE. In the discussion of M2 and to some extent M3 in both the paper and the Bluebook, Steve, the numbers that you are using seem to suggest that you're looking almost immediately for the downward movement in velocity to end, except perhaps for the shift adjustment. I note that in the third and fourth quarters we had a decline in V-2 at an annual rate of around 5 percent. If that were to continue into the first half of next year and we added that to the GNP number we wanted and added another 3 points for the shift adjustment from market instruments into M2, we could have a very large number indeed, like 15 percent. Is there some reason, other than hope, that you think [the adjustment in V2] is about to end?

MR. AXILROD. Actually, we're thinking in terms of an underlying [growth in] M2 in 1983, independent of shifts, of something like 8 percent. And we have nominal GNP growth on the order of 7 or 7-1/2 percent, so we have a slight--

MR. PARTEE. Very little.

MR. AXILROD. --downward movement in velocity as not out of keeping with that. It's hard to tell exactly what would happen, but we feel that when we get to the point of price stability--and I don't know whether we'll get there, but assume we get there--that the store-of-value function of money will be restored in some sense. People will be more willing to hold money at any given level of interest rates for its store-of-value function because they are not losing purchasing power. At least that is what we think. So, from that perspective, there'd be a one-time increase in cash balances when that occurred. I would be very reluctant to predict whether it would occur next year; it seems somewhat doubtful to me, but it may. The basis for our assumption for next year was that some of this present liquidity that has been provided would tend to be used up. We're not using up much of it because we still have a slightly downward tilt to velocity. If we're using up a lot, we might see velocity go up and we would have a somewhat more rapid recovery. We have projected a rather calm picture with no rise in interest rates from around current levels in the course of next year. On that thought we have not projected what many are predicting--that there will be a sharp turnaround in velocity. We do have it calmer.

MR. PARTEE. Yes, but [velocity is projected to be] a lot less than it has been. We were getting a decline of 5 percent and now you have just a very little decline.

MR. AXILROD. Right.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I'd like to begin by commending Steve and his associates for what I think is a very good paper. I might add that I've heard everyone who has discussed this say the same thing. I agree with a lot of its major conclusions, particularly that we just can't use M1 as a target in the intermediate period. I think M2 is probably the best target that we can use. I don't see where we can really throw M3 in there. But I believe there is some difference between the staff position and my own as to the emphasis we ought to give M1 at this point. The paper clearly recognizes, it seems to me, that it is desirable at some time to return to maintaining some kind of relationship between M1 and our policy. But [the paper] seems a bit vague to me [on that point], and I would like to see us make that a little more definite. Most of you probably are not going to buy that view at this point, but I'd like to see some kind of commitment to return to M1 targeting by mid-1983 unless it clearly is not possible to do so. I don't think we really know whether it will be clearly impossible or not. I favor this for two reasons. One is that I think the pricing policies of Super NOW accounts and money market deposit accounts is going to be pretty well set by midyear and the lion's share of that shifting is going to be behind us. From then on out we should be able to use M1 itself or develop some reasonably good shift-adjusted M1 that could serve for targeting purposes. My second reason is that in the past--it may not be true in the future but presuming that it will--M1 has been a better predictor of the behavior of nominal GNP and prices over the long run, despite all these regulatory changes that people thought would destroy its validity. I think it's quite possible--in fact, this is what I think will happen--that the money market deposit accounts and the Super NOWs will be priced so that most of the savings and investment money will go into the money market accounts and most of the transactions money will go into the Super NOWs. And in that case I see no reason why M1 wouldn't continue to bear a pretty good relationship to nominal GNP and prices. So, I would like the presumption to be that we will go back to M1 unless we find that we can't do it. That would be my main emphasis.

I have two more points beyond that. One is that I would recommend very strongly that we devote whatever resources are necessary to see what we can do in the way of developing a reliable shift-adjusted [M2]. I realize that is not an easy thing to do but I think it's something we have failed to try. My second point is that I like the idea of the shadow target but I reach a somewhat different conclusion from Jerry on that. I'd feel a little better if we bumped it a little higher because it's not practical for the Committee to participate in these ad hoc adjustments made to the borrowed reserve target between meetings. So, I would like the automatic part to be larger than it has been in the past. I think I'll stop right there.

Well, one other point. If the interest elasticity of M2 is less than that of M1, as it probably will be, and if the elasticity of M1 is less than it has been in the past because of this innovation, then I think we necessarily would have some larger movements in interest rates than we've been willing to tolerate, if we're going to stay on whatever path we finally end up with. So, all of these things lead me to suggest that the automatic adjustment mechanism ought to be made as strong as the Committee is willing to accept.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, I share Bob Black's comments on the paper. I think it's a very fine paper, and not only because I agree with most of what is in it. But it does not make it very obvious where we should go from here.

MR. PARTEE. You mean we have to deal with that too?

MR. FORD. He kept looking for the bottom line!

MR. WALLICH. I would like to note that if you want a survey of targeting possibilities, some are not in the paper. While I wouldn't recommend these, I think there are serious contenders. One, on the basis of the research done here at the Board, is that the use of intermediate targets is inefficient and that better and more precise results can be obtained by targeting on the real sector directly. On the other hand, there are many arguments against that, including the political one, but it is something that one ought to bear in mind as one makes these choices. Also, I note that there is nothing in the paper about exchange rates. Again, while I don't think exchange rates are a proper target for this economy, they are targets that are used in other countries, in the EMS countries for instance. That again is something to think about. I would think certainly that exchange rates might play a greater role in our targeting in the future than they have. We have a little sentence [on them] in the directive but not much attention is paid to them. Finally, there is a reference to nominal GNP. You may recall that Martin Feldstein came here a few weeks ago and gave us a talk recommending that we target on that. I think that's dangerous advice. It means playing God, and the central bank should be a humble technician administering the aggregates and not trying to say what nominal GNP is to be.

On M1, I share all the points made in the paper. I think we have to wait and see if we should use it, if it becomes viable again. What I hear from the market is that the money market deposit accounts may prove more attractive or may be made more attractive by the banks than the Super NOW accounts, but we will have to wait and see. Certainly M1 is the one element in money supply targeting that to me carries any real conviction; with M1 we are dealing with transactions balances and there is some reason to think that they do guide the economy--of course, always through interest rates. On interest rate targeting, which is rejected in the paper, the way I feel is that they are what we should target on if we had the knowledge and no political difficulties. But we have a great difficulty, of course, in deciding what the right rate is and it would be difficult to sustain it in the face of opposition. But since I believe the economy runs on interest rates, not on money, it is in one sense better to target directly on interest rates than it is to target on money and let money determine interest rates.

Well, to come to what is doable, I think M2 is our best bet in the short run. We have to keep it very flexible with a wide range around it. It is attractive in the sense that trying to control it produces large changes in interest rates which control the economy effectively even though we do not control the M2 aggregate itself very effectively. We may have to accept considerable deviations. The base, I think, perhaps deserves a little more support than we've given it here, particularly the nonborrowed base. Fundamentally, of course, the base is currency and it's hard to believe that the economy runs on currency. However, currency is about the best behaved variable we have because it's the one about which the least is known! Most of these $500 dollars per capita that we have in the form of currency presumably isn't active in the American economy--[it's in other countries such as] Mexico or destroyed. The base, because it is a fairly stable aggregate, is a safe aggregate to target on and one that would not give us a great deal of trouble, particularly because we can make allowances for misadventures to currency such as [possible] large shipments to Argentina or a boom in the underground economy. But other than that, I think the nonborrowed base has something to commend it. On credit, I feel the same way as the paper does. It is informative; it has meaning but it is technically difficult. The data are poor, late, and subject to revision. And it is difficult to control. So, I would go for a credit aggregate larger than bank credit as an associated device. Thank you.

CHAIRMAN VOLCKER. You didn't mention prices on your listing of targets.

MR. WALLICH. Well, as I contemplate setting a price goal, were we to put the CPI at 350, then aim at it for five years and overshoot, we would then have to bring that price level down.

CHAIRMAN VOLCKER. Is that very different from the aggregates?

MR. WALLICH. Yes, the price level, of course, is a part of the real sector and that's what we need, I agree. But I think that is where the emphasis on using instruments protects us against the failures that are almost certain if we were to target on prices.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. Like Bob Black, I certainly thought that Steve and his associates did a fine piece of work. It is a really systematic, in-depth examination of the pros and cons of different options. It is a bit frustrating I'm sure, Steve, to have done all this work and not come up with any positive clear-cut view, but that is in the nature of these things. We are faced, I believe, in the short run here with a lesser evil in a way. I'm a little less optimistic than you are, Mr. Chairman, about the possibility of knowing considerably more by February than we do now, and I'd just like to suggest a couple of reasons why this uncertainty may go on for a while. You know better than I that the DIDC may drop another shoe, so to speak, at some point between now and midyear in the form of Super NOW accounts for business. I'm not sure to what extent that might change the behavior of the aggregates, Steve. Perhaps you could comment on that when I get through, please.

Another thing that may continue this uncertainty a little longer than perhaps is indicated in the paper is that there is some indication--I think I just read it in this morning's Wall Street Journal--that the standard money market funds are beginning to fight back now. And that certainly is just the opening gun in a battle that may go on for quite a while. The specific instances that you probably read yourself this morning were with regard to Fidelity and Vanguard funds, both of whom have made arrangements with banks to shift their funds to a bank in case the customer insists on a bank-type money market account. Fidelity is hooked up with some bank; I can't remember what it is.

SPEAKER(?). Continental.

MR. BALLES. Oh, Continental. And Vanguard is going with the [Bank of] Boston, I believe. Heaven knows what this is going to do, with the amounts showing up in M1 and M2. So, I just don't have a feel as yet as to how long this uncertainty will go on. But I certainly agree with what I think was your conclusion, Steve, that it would be premature to dismiss M1 forever. On the other side of the coin, I feel it would be premature, using the words that Bob Black started off with, to commit to returning to M1. That [wording] would be a little stronger than I would be prepared to support. But I agree with Bob's concluding comments that we certainly ought to make it clear that we will be prepared to re-examine M1 when the dust is settled and very possibly return to M1 as a target.

Meanwhile, my very, very tentative instincts tell me that if M1 doesn't settle down and start behaving in a way that has a predictable demand relationship and predictable effects on the economy, the nonborrowed base might be the thing to look at much more closely. But I think it would be a mistake to move to something as esoteric as the nonborrowed base just for some interim period if there's any hope at all of M1 finally settling down in a way that we can use it. The problem of explaining the nonborrowed base to the general public, the Congress, and so forth would, I think, be very formidable. Meanwhile, I think you have come up with a good--in my opinion, the best--interim solution, which would be to stay with M2 for some months ahead and see what happens to the behavior of M1.

CHAIRMAN VOLCKER. I didn't want to suggest, if that was the inference that you drew, that all this would clarify itself by February. I only drew the conclusion that maybe we would have talked it through a little more by February, not that the numbers would suddenly clarify themselves. You had a question for Mr. Axilrod.

MR. AXILROD. One of the reasons we suggested midyear as the time to relook [at M1]--and we were a little hesitant about that--was the thought that the DIDC presumably would have this interest bearing checking account for businesses coming on stream, although I'm not sure [that will happen], by early spring. So there would be a little more time to see how that behaves. I would assume the adjustment to that might go a bit faster than for the others but I really have no way of knowing in advance.

CHAIRMAN VOLCKER. We will have Mr. Morris, and then Mr. Roos will give us the opposite side.

MR. MORRIS. To consider returning to M1 by mid-1983 is extremely unrealistic, I think. Not only do we have the potential of these corporate accounts but we also have the experience that it takes a long time for people to adjust fully to changing their cash balances. The New England experience with the NOW account was that it took three years to reach equilibrium with NOW accounts. I never did believe the idea that the change would take place that much more rapidly in the country at large. And the fact that NOW accounts have been growing over the past year at about a 35 percent annual rate leads me to question the maturity of this device. So, I don't think we should expect that the public is going to adapt to these new accounts very rapidly. It seems to me that goes against the grain of all our earlier history. Neither should we expect that money market mutual funds are going to sit back and let the banks take all their money away from them. I would expect, for example, that the next move by the money market funds would be to offer unlimited checking. We already have unlimited checking with Merrill Lynch's cash management fund.

MR. FORD. And no minimum size of check.

MR. MORRIS. No minimum size check and no limit on the number of checks. One pays for the cost of processing with a service charge. If the Super NOW account turns out to be very popular, which I think it will, it seems to me that the money market funds will respond by offering unlimited checking, which will open the ballgame again. When the dust does settle sooner or later--I think it's unlikely to be by mid-1983--what we call M1 is going to be a very different animal, as Steve indicated, than the M1 of earlier years. And it's going to take us 5 or 6 years of experience with the new animal to develop any consensus as to how it's going behave relative to nominal GNP and how we can control it. Certainly, there is no scientific basis for expecting that it is going to behave relative to nominal GNP in the same way that the old M1 did.

There is a lot of theology on M1 floating around at this meeting. Steve mentioned a couple of things that raised some of the basic issues. He talked about the vexing questions of cause and effect in using credit as a target, as if to suggest that there are no vexing problems of cause and effect with respect to money, a point about which I would raise serious questions. I agree with Henry that what moves the economy is interest rates and not the black box. Steve also raised the question of whether credit can be controlled independently of GNP. I suspect that it cannot. But I have not seen any demonstration in the last three years that we control M1 independently of GNP. The idea that M1 is so interest-sensitive that we can control its rate of growth by interest rate changes so small as not to have any impact on the economy I find hard to believe. I cannot reconcile that theory, that doctrine, that theology with what has happened in the past three years when we finally made very big moves in interest rates to get M1 under control and those big moves had very big impacts on the economy. So, I find a lot of conflict between the facts and the theology in the case of M1.

I think we need a proxy--an independent intermediate target--for nominal GNP, or the closest thing we can come to as a proxy for nominal GNP, because that's what the name of the game is supposed to be. If we have to target something that is not predictably related to GNP, which M1 has not been in the past two years, one of two things can happen. One is that we can do as we did in 1981 and say the M1 shift adjusted, which was our target, is coming in too low and we are just going to let it come in low--we're not going to use it as a target de facto. I think that was the right decision. If we had tried to hit our targets for M1 in 1981, we obviously would have put too much money into the system. I think the targets have misled us this year. That is, up until October when we finally caught up with it, it seems to me that the monetary aggregates misled this Committee into following a much more restrictive policy than we intended. And that is reflected in a nominal GNP growth this year, which we're now estimating at 3.6 percent, that I don't think any of us a year ago would have [favored] as a target for nominal GNP.

It seems to me that the best proxy for nominal GNP in this world of enormous change is the rate of growth of debt. Now, that may not be a perfect proxy, either. But we certainly don't want to go back to interest rate targeting. Politically, I don't think we could adopt a nominal GNP targeting approach even though theoretically that is what we ought to be doing. I don't think we can do it. We need a proxy for nominal GNP.

CHAIRMAN VOLCKER. What is that political objection?

MR. MORRIS. Well, let's say the President comes out in January and says we are going to have 12 percent nominal GNP growth, and you go up before the congressional committee in your Humphrey-Hawkins testimony the next month and say we're going to finance a 9 percent nominal GNP growth. It seems to me it is not well suited to the needs of the central bank to be that far out on a limb.

CHAIRMAN VOLCKER. How far do you think we can go in that regard by saying we're going to project a 9 percent credit growth or 9 percent M2 growth or something that is inconsistent with the 12 percent [nominal GNP growth]?

MR. MORRIS. I would merely submit that we've been getting away with this on the money supply for a number of years. I'm quite amazed that we have. But I think it's very clear that the intermediate target should not be politically sensitive. And the wonderful thing about the rate of growth in the money supply, for all of its problems, is that it was never a politically sensitive item such as the unemployment rate, or interest rates, and so on. Nominal GNP, if we were to use that as a target, would be a politically sensitive target, and we ought to avoid it for that reason. But we need a proxy for it.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. I think I'm going to miss you. The only way I'll ever be able to get my blood pressure up is to go back to arguing with my wife again! The impression I got from the paper that Steve and his associates put together--and I certainly can't add anything to it--is that all of these targets are flawed in one or more ways and that perhaps M1 presents fewer problems than the others. I was tempted to conclude after reading that paper that there really may be no way to do the job with any certainty. Maybe we ought to look at a lot of things and not concentrate on any one target, as some of us are quoted as saying. But I'm not sure that that will work. In the last few months we have looked at a lot of things; and although the M1 figures that we're seeing may be meaningless, that 16 percent growth over a quarter is disturbing to a lot of people.

It seems to me that we have two primary objectives in this Committee: One is to achieve as low as possible a level of inflation, and I think we should get very good marks for having achieved that, which incidently we achieved by a consistent lowering of M1; the other and probably the more immediate concern at this moment is to try to achieve an improvement in economic conditions. As I see it, the worst thing that could impede our desire to improve the economy domestically and our hope for improved international economic conditions would be for interest rates to climb rather dramatically--if we had a significant backup in interest rates, at least at the long-term end, which I think is perhaps the most important ingredient in the market's perception of what we are doing.

From the few people I've talked to, I sense a nervousness among some market participants in reflection of the problems that they know we face and in our statement that we would have to, for very understandable reasons, pull away from M1 [as a target] for a while.

The question on the minds of those that I've talked to is: Is this going to be temporary or is it going to be permanent? Rightly or wrongly the markets and the public generally have come to look at M1 as something that is important. And if we're going to reject M1, it's going to have to be done in a very convincing way because that is the measure that an awful lot of people look at. I would endorse what Bob Black said in that I think that it's terribly important, though I don't how to do it, to emphasize that we have very serious intentions of coming back at some time to M1. I would like to see our 6-month projections include some M1 figure, maybe with a much broader band, say, 5 or 6 points. But that would at least give credence to the fact that we are not dropping M1 and that we really have something with which we're steering this ship. I don't think we can say--and certainly nobody at this table would want to--that because this problem is so complicated we're just going to run our business by the seat of our pants, because that isn't going to be satisfactory and it isn't going to be productive. This has nothing to do with theology. I would hope, just for the sake of market perception, that some credence is given to M1 and that the Chairman will make a very strong statement that for the immediate future M1 is seriously flawed but that it does have certain long-term advantages not shared by most of the other possible targets. I hope we will say that we have not forgotten M1, because once the markets think we are in effect closing our eyes because we're overpowered by this complex set of circumstances, I think we're in for real trouble. I would just point out in closing that when the NOW account situation presented itself to us, as I recall, we really overreacted to the complication and the [duration] of the complication due to NOW accounts; that settled itself after a relatively short period of time and we were able to adjust. I think we ought not to abandon M1 totally.

MR. MORRIS. I disagree with that statement that we have adjusted for NOW accounts. I don't think we have at all.

MR. ROOS. Well, we were able to drop the adjusted M1, Frank, after less than a year. And according to the analysis our research department did, had we targeted on unadjusted M1 and never had that adjustment we would have had a relatively pretty result that year.

MR. MORRIS. Well, I would submit that the rate of growth of M1 in 1982 would have been substantially less than it was--that a lot of the NOW account money would be in savings accounts.

MR. ROOS. Well, of course, Frank, we have the capability of making our target, whatever it is, perform as we want it to through our open market operations and other techniques. So, if it didn't perform in accordance with our desires, it may be that we didn't lean on it to the extent that we should have, but anyhow--

CHAIRMAN VOLCKER. Suppose it is true, Larry, that we can make it perform just the way we want. Say we put a target out there and we are right on the target with M1 but the unemployment rate is at 20 percent.

MR. ROOS. You pointed out in a very persuasive way at the last meeting that it was a matter of choosing risks, and I would agree with you. But I fall out with some of this reasoning in that I believe that if the markets get the impression money is growing too quickly, interest rates are going to shoot up and we're going to be faced with--

CHAIRMAN VOLCKER. But that is what I'm addressing myself to. If markets have that impression, some people anyway are going to be nervous; I think they are today. But suppose we were in this dilemma where money has to grow faster to keep the GNP up. What are you going to do?

MR. ROOS. Well, we may be between a rock and a hard place.

CHAIRMAN VOLCKER. With that I agree. Governor Gramley.

MR. GRAMLEY. The staff called our attention repeatedly to the range of uncertainties in these estimates, and I'd like to start by stressing that. If one takes a look at table 2 in the Bluebook on page 8, one sees the staff estimates that for the year 1983, fourth quarter-to-fourth quarter, flows to M2 will add somewhere between 1/2 and 2-1/2 percent to the growth rate of M2. But they get to that conclusion by going through a whole series of instruments and by making estimates that are often clever and often well conceived but in the final analysis are off the wall. That is said not in any way to denigrate the work of the staff. There is simply no one who can know whether out of the $350 billion in CDs $1 billion or $50 billion is going to shift. Now, if these uncertainties are bad for M2, think of what they are for M1. From my standpoint, when the estimates for 1983 imply somewhere between a reduction of $8 billion and an increase of $24 billion, which is an increment of from minus 2 percent to plus 5 percent for the growth of M1, that aggregate is a very dangerous target until these things settle down.

There has been some suggestion that the way out may be to look at something like the nonborrowed base. I don't interpret the staff documents the way others must be interpreting them. The staff said that if we start with these problems and go back to the total monetary base, we'd be dealing not only with all those problems but one more: the instability of currency demand. Therefore, that is going to be a horrible target. Some of this horribleness would be removed a bit if we went to the nonborrowed base. To focus on what the nonborrowed base would mean: If the demand for money is -4 and we're trying to push out 10, we're going to be dumping in reserves like gangbusters. So, borrowing will go down to the floor to keep the nonborrowed base exploding and interest rates will fall. And we are just going to be all over the place. We are going to have wild instability in interest rates. As I look at what the staff has said, the best we can do at the moment is to focus on a broader aggregate like M2. I come to that conclusion not without some sympathy for where Frank Morris is. But the main problem with a credit target is that we simply don't get the data with the kind of timeliness we need in order to make it a sensible intermediate target for monetary policy. It's just not there.

MR. MORRIS. Could I add a point here? My staff has estimated that we can produce a monthly debt number two weeks after the end of the month. We sent their analysis down to Steve Taylor and Steve said it was right.

MR. AXILROD. No, he didn't.

MR. MORRIS. Well, maybe he told them it's right and he told you it's wrong.

CHAIRMAN VOLCKER. The answer to this question depends upon whether or not one is in favor of a credit aggregate.

MR. AXILROD. It's closer to three weeks or four. It depends on how much estimating one wants to do. But on the same basis that your staff has, President Morris, we would estimate around four weeks unless we wanted to do a little more estimating than is actually implied in that memo. It's a technical difference, but I think there is a difference. You might do it in two weeks. The truth is that we don't have such a series. We don't have it seasonally adjusted. And we don't know anything about its volatility characteristics. The last time we had one--and we could develop it again--was about 15 years ago when Governor Partee and Governor Gramley were running the division.

MR. PARTEE. It was at least a dozen years ago. It was so volatile we couldn't--

MR. AXILROD. It was so volatile, actually, that we gave up on it. It can be developed. I don't think the lag is two weeks; I think it's closer to three or four. But it certainly could be estimated. Our estimate is 65 percent in two weeks as against your 85 percent; we could estimate that 20 percent and add it and not be terribly far off. But we don't have it available in any real sense and it hasn't been tested. That doesn't mean it couldn't be developed or shouldn't be developed. But we're not near it, in any real sense, from our point of view. But if the Committee wants--

MR. GRAMLEY. My own line of thought on this is that for the moment the best thing we can do is to focus on M2. I think we ought to shift adjust it; I would agree with Bob Black that we ought to get the best figures we can get. But I want to call to the Committee's attention that with the kind of uncertainties we face, there isn't really a serious choice theoretically as to whether we ought to be stabilizing interest rates or stabilizing quantities. The theory of stabilization of quantity develops from the hypothesis that demands for money are more stable than demands for goods and services so that greater stability can be provided to the economy by focusing on quantities and stabilizing them than by focusing on rates. My own guess would be that we're in a situation now, if we're going to use monetary aggregate targeting, where we have to be a lot more flexible than we have been in the past. And we have to give a lot more weight to seeing to it that interest rates don't go through wide swings. I think that's also the implication of what Steve has been telling us for some time about the insensitivity of demand for M2 to changes in market interest rates. If we are not very careful--if we try to control M2 too closely--we're going to see interest rates moving all over the map. And, frankly, I don't think the present very fragile state of the economy will permit that.

MR. BALLES. May I ask a question, Lyle? With regard to your statement that you consider M1 to be a very dangerous instrument, was that in this interim period ahead or more or less indefinitely?

MR. GRAMLEY. For however long it takes for the demand for M1 to settle down. Maybe it will settle down by midyear; then we can reconsider that decision. I'd hate to decide now, however, that by midyear it will definitely happen, because as you mentioned, John--

MR. BALLES. I agree with you then.

MR. GRAMLEY. --the new accounts for businesses, which may in effect end the prohibition of interest on demand balances, may come along soon or it may not. Who knows what is going on?

MR. BALLES. We'll all reserve judgment.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman.

CHAIRMAN VOLCKER. Wait just a second.

MR. MORRIS. You started out talking about the flow impacts for M2 and how they are off the wall; it surprised me that you concluded that M2 is what we ought to be targeting on.

MR. PARTEE. Flexibly.

MR. GRAMLEY. What I said was: It is better than M1 and I know of no alternative at the moment. And because of those uncertainties, I think we have to use a lot of flexibility--in effect give a lot of attention to how much movement of interest rates we're willing to tolerate to shut off an excessive growth of M2 or to stimulate growth that is too low. If we're not awfully careful, we're going to be chasing an aggregate the demand for which is being changed by financial innovation rather than something fundamental going on in the economy. That's why I want to shift adjust this as soon as [possible].

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. Lyle has said very much what I wanted to say; I may just go at it in a little different way. I agree with those, however, who say that we shouldn't bury M1 totally. We ought to keep it in the background. It has served us very well politically in the past. Perhaps it could again. It may have some informational content, as everything settles down, that we will want to use in the future. As a result the fact that we merely set it aside for some period of time to be looked at again is important. Lyle has made the point that I wanted to make with regard to the interest rate volatility of the proposal made in the paper, using what I think is the only reasonable variable to guide us in the future, and that is M2. We'll have to pay more attention to interest rates and thus perhaps build in an interest rate target, whether we publish it or not, that constrains some [rate] movements.

I would just ask a question of Steve or others with regard to M2. It looks to be very stable on a quarterly basis, but if you look at it on a monthly basis, just taking this year as an example, it has ranged from about 4.4 percent growth in February and what would be 4.5 percent in December, if we hit that [estimate], up to about 14 percent. In about 6 months of that period it was above 10 percent and [in the other] 6 months it was below 10 percent. The question that I would pose to Peter or Steve is this: How does the Desk propose to operate without some interest rate constraints? I'm saying, as Lyle has just said, that we have to pay more attention to interest rates; I don't understand how the Desk would accommodate either an increase or a decrease in the nonborrowed path for the purpose of trying to adjust [operations] in an intermeeting period on [the basis of] a directive given to the Desk following the meeting.

MR. AXILROD. Well, in general, M2 is less volatile than M1, though it is volatile, of course. But what would happen as it moved off a path is that the built-in response would, in fact, be less because it is less volatile than M1, fortunately. So the built-in response could be less and the practical question would be [whether to take] a $200 million, roughly, movement of total reserves beyond where the Committee wanted it on average to trigger an ad hoc adjustment to the nonborrowed [reserve path]. It may be as we gain experience that it will turn out to be more [appropriately] like $100 million movements if M2 is targeted. That would trigger a downward movement of some amount in the nonborrowed path because the automatic adjustment isn't big enough. That's the nature of what would happen.

MR. GUFFEY. But you're going to expand that when you go to the shadow type of reserve requirement--the 3 percent as opposed to the 2 percent?

MR. AXILROD. Well, that would only be if the Committee wanted to; we just suggested that.

MR. GUFFEY. Well, my point is the one that Lyle made: This Committee should pay attention to interest rate movements, if we're going to target on M2 as suggested by the paper, using a 3 percent shadow reserve requirement. Interest rates have to be more important to the intermeeting operations of the Desk.

MR. AXILROD. One thing I may not have made clear, Mr. Chairman, is that the way the shadow requirement was set is that we figured out what would give us for the average variation in M2 the same average variation in interest rates that we have had. M2 would move a little more [in relation to] that [interest rate] variation than M1 would have, but the economy would be roughly the same. If you take M2 times its velocity, you would be getting roughly the same GNP. So, you get the same interest rate movement, but because M2 isn't as interest rate sensitive you can get a little more [change in] M2 than you would have in M1 relative to its path, but roughly the same GNP outcome because the velocity behavior will be offsetting to a degree.

MR. GUFFEY. Isn't it true that if we had been following this for the last six months, we would have had interest rates moving up in a period of time, say, in the fall--September, for example--when that would not have served the Committee's purpose well?

MR. STERNLIGHT. Well, we were operating with instructions to be accommodative of some overshoot of M2 as well as of M1.

MR. GUFFEY. Well, I guess that makes the point that I want to make: That being flexible with respect to the interest rate range that I think should be established by the Committee at this meeting is an important ingredient of targeting M2 in the period ahead.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Well, Mr. Chairman, we've heard from the theologians and now we will hear from someone who is maybe not agnostic but at least a little more eclectic. To me it's very clear that we will continue to need some kind of rule that is more flexible. I think we need that for the reasons of self defense, in a political sense, that have been identified by many others. But we also probably will need it for a self-disciplinary reason as well. The point will come, though I don't know when, when there will be a need to raise interest rates or to tighten or whatever you want to call it. And for purposes of this Committee in terms of its internal functioning as well as its external relations, a rule serves a very good purpose. Again, it should be a flexible rule, too. There has been some question about nominal GNP and things like that. I have a lot of problems with those kinds of objectives. If we were to pick something at that level, I'd be more inclined to pick the price level, but even that to me is a can of worms. It puts us in a no-win situation in terms of our ability to deal with other problems, the political problems included. The biggest difficulty I have with a lot of the discussion, at least implicitly to this point, is that there seems to be some sense that after all these shifts have taken place our problems will go away. I think that may be just when our problems will begin because after the shifts have taken place, each of the aggregates, M1 included, is going to mean a different thing in relationship to GNP and interest rates and velocity and the price level and everything else. Now, we try to capture that difference by saying in some sense that the interest elasticity in the future will be at least different, and in most cases smaller, than it has been in the past. But I'm not sure that even that statement fully captures the extent to which the various Ms will be indicators that tell us things in the future that have much of a bearing on what they have told us in the past.

Whatever else all of that means, I think it does mean unequivocally that the danger of interest rate overkill, even with M1 after all these shifts have occurred, will be greater and indeed potentially significantly greater than it has been in the past. I do think that for the next three or six months if need be we can probably muddle through--if that's the way to describe it--along the lines implied in the Bluebook and suggested in the larger paper, partly because we have a built-in smoke screen for that period and partly because, in my judgment at least, it will be extremely unlikely in that timeframe that we will have to come to grips with the need to tighten monetary policy materially. My suspicion and my hope would be that when the transition is finished we will know enough about M1 that we can use it in a more flexible way, but I'm not even sanguine on that point. It is probably a premature judgment. But I do think, as may have been implied by Mr. Guffey's comments, that at some point we are going to have to take a more in-depth look not just at the question of which of these indicators should serve as the primary guides to monetary policy, but a fresh look at the operating side--questions as to how to draw a reserve path and what kind of response mechanism to build in automatically. Otherwise, my hunch is that six months or nine months from now it is still going to be a pig-in-the-poke in terms of which one of these variables we think is best. And if that's the case, what will become more important at that time is the manner in which the Committee wants to go about trying to steer--and I say steer, not control--the variable or variables that it thinks best suit its overall purposes.

CHAIRMAN VOLCKER. I hear all these comments about the political viability of targeting nominal GNP, which I understand. I want to offer an observation. I would be very surprised if we got through the hearings in February without being asked to reconcile directly whatever target we have with whatever nominal GNP the Administration has. And if it does not reconcile, we're going to have a big problem.

MR. FORD. You could always change your inflation forecast.

VICE CHAIRMAN SOLOMON. We have the nice range on velocity of circulation to use to reconcile.

MR. MORRIS. If you use a velocity number, they can't prove you're wrong.

CHAIRMAN VOLCKER. And we say they have to accept that figure. That's--

MR. FORD. You're saying you have to agree with their nominal GNP forecast?

CHAIRMAN VOLCKER. There will be an effort to push us into that, without any question.

MR. FORD. Does that mean you have to agree with their inflation forecast?

VICE CHAIRMAN SOLOMON. That's not the problem.

CHAIRMAN VOLCKER. There is a little room for maneuvering, but I think we're not going to be so lucky as we were in past years in evading that issue. Governor Martin.

MR. MARTIN. Several of us have commented on the probable length of time of the transition. I'm one of those who come down on [the side of] the long transition theory. It has been said that the length of time it will take before [we can assess] the behavior of the new instruments and indeed the old instruments, which also may have their interest ceilings changed or removed by the DIDC, depends on the aggressiveness of bankers and their marketing efforts. I think that's incorrect because I observe that the commercial banks in the country are going through a few other phases and adjustments right now. If you add in thrift institutions, several dozen of them are failing every month. That's a rather difficult transition. Now they are going to be adjusting to noon presentment [unintelligible] and all that implies with regard to the clearing processes, and to ten percent withholding, which is putting a slight strain on most of their paper shuffling. There are loan write-offs, international complications, etc., etc. If we shift our view from concepts and abstractions to what is going on in the institutions that are out there, I think one can at least make a case that the transition period is going to be rather extensive. And I would suggest to you that the consumer is almost as confused as his friendly neighborhood banker. It's going to take those consumers a while to settle down and determine where they want their balances and how much and what kinds of services they want from institutions that are changing their offerings of services rather frequently these days.

I'm not as concerned about the journalistic recitation of expectations of the markets as I am about the behavior of the markets themselves. I don't believe that Milton Friedman, my old friend Herb Stein, Lindley Clark, and the rest of those good folks are going to determine how the market reacts to what we do here in terms of M1 or M2 growth targeting, the changes in the directives, and so forth. I think market participants are much more likely to react to the continued flood of negative or at best neutral information with regard to the company they underwrote last week, last year, or two years ago --literally to the bottom line of a corporation whose securities they are attempting to make a market for--to unemployment, to the export industry complications, to shortfalls in business fixed investment, and to all the rest of what is happening in the real world, and not to what Lindley Clark says in The Wall Street Journal. Therefore, I think we have some action space to pursue some aggressiveness in M2 and some tolerance of M1 because the real world is just not shaping up very well for 1983.

So, I'm endorsing what has been said with regard to a continued surveillance of M1. It is certainly attractive. We've all exercised our due diligence now and looked at many of the other measures. And, certainly, we should try to reinstate M1 in the pantheon. But in the meantime, in what I think will be a long transition period, I would hope to see us discuss in our directives and our public utterances both M2 and M3. I'm not wild about M3 as a marvelous measure. But look back at those tables on velocity at the end of the excellent work that has been done here. I would hate to see us confined to one measure among the aggregates when velocity one year is +4 percent and another year -5 or -5-1/2 percent. I'd like to see us have a little flexibility in the aggregates targets and, lacking something better, I would suggest M2 and M3. It's a bit vague; certainly M3 is a bit vague. For that matter M2 is not a model of clarity. But I'd like to see M2 and M3 specified and a little more emphasis in our public utterances on interest rates. We're not fooling anybody, you know. The folks out there know that we're paying a little more attention to interest rates. Why not come right up front with it? That we look at M2 and M3 as the validator is a plus. I think the word flexibility is part of the key to this. I wonder back on the discount rate cut, which wasn't exactly a world beater, what the markets would have done, as they firmed up, if we hadn't reduced the discount rate. So, I opt for flexibility.

CHAIRMAN VOLCKER. I don't know how much longer [we can continue]. We're not going to get through everybody on this [issue today]. Not everybody wants to say something. Maybe we can go through a few more. Mr. Boehne.

MR. BOEHNE. Well, I think it is the time for focusing on what works rather than some predetermined theology. That is clearly what we need. Jerry Corrigan put it well: An intermediate target is a very useful thing to have both for political and self discipline reasons. I think it's going to be a while, if ever, before M1 is clear. The idea that M1 is going to clear up enough by midyear just strikes me as unrealistic. Perhaps it will, but I think it is going to take a while for the reasons that Pres Martin mentioned. I would go with M2 as a primary target and with M3 as a secondary target, using credit as an informational variable. But I certainly would stay quite flexible, with a sharp eye on interest rates.

With respect to the point that you raised about making our targets consistent with the Administration's, it does seem to me that velocity gives us a fair amount of leeway. [This year] we've had the sharpest drop in velocity in the postwar period, and heaven knows what velocity will do next year. It would seem to me that quite wide ranges could be very helpful in terms of being consistent with what we think is appropriate for M2 and M3. As to when or whether we will ever get back to M1, I would approach the issue with complete pragmatism, not a theological bias, and just keep an open mind. If it does clear up and we can make a case that it's a reliable variable at some point, then it's fine with me to go back to it. But I don't think we ought to force it.

CHAIRMAN VOLCKER. I don't think this velocity argument is going to work during this period; it will work the other way around if they are at all smart, which may be an overestimate. They are going to say "I see velocity went haywire last year, so you have to give us a commitment that you're not going to follow that target but are going to adjust for whatever velocity does. And you better hit that nominal target."

MR. BOEHNE. I have a great deal of confidence in your ability to fuzz things up and to cut through to the--

CHAIRMAN VOLCKER. Paula Hawkins may not let me. Mr. Ford.

MR. FORD. What is motivating me in my approach in this very complex time that we are going through is that the more complicated things get, I tend to react to them by going back to the more simple things we know more about. There are two things that worry me. One is what worries everyone else on this Committee, and that is that the tune is changing on us in our waltz with M1 or M2 or anything else we use. And if, as a result, we don't provide enough liquidity, then the economy is [going to be] down to where the chart outside your door shows it is. I think there was a time when we had charts on the monetary aggregates on the wall, but there are none left now; it's just interest rates and the unemployment rate by your door. When one looks at what is happening in the world, we are worried seriously about creating a depression here. That is implicit in Chuck's question: How do we know velocity won't be even worse? The obvious answer is that usually we'd be thinking about [the economy] going the other way in a normal, cyclical manner. His feeling and that of many of the people on the Committee is that we basically are in an historically discontinuous mode. Things aren't relating in the way they used to; innovation is messing up the picture and, therefore, the big danger lies on the side of retaining some kind of religious commitment to any one of these monetary variables we're fooling around with and overstaying the period of recession and causing a crash. That is what is on our minds; that's what it's really about. At all costs we must avoid not doing the number one job of central bankers, which is to keep enough liquidity out there to keep the economy going. That is what you are worried about and that is what we are reacting to and that is why we are backing away from most of these things. The innovation arguments are part and parcel of that.

There's another thing that worries me. It comes from my background as a professor of economic development and history. And that is that if you look at the longer-range experience of what central banks in this country and other countries have done wrong on numerous occasions in this century--especially in other countries earlier in this century--there is another thing we can do that would be terribly wrong. I think we're doing it now. And that is to validate the classic mismanagement of public policy of a government, and I mean both domestically and in foreign countries. What I see happening in our own country under Reaganomics is that we have had an enormous increase in the size of the public sector relative to the private sector. There has been a tremendous increase in public spending and, under Reaganomics, it has shifted away from investment-type activities toward consumption-type activities; defense expenditures can even be called consumption.

Around the world we are looking at Mexico and asking what is wrong with Mexico. The answer is that the Mexicans are consuming publicly much more than they are willing to produce and to tax themselves to support. There, too, the problem is public sector expansiveness that they have validated internally with monetary expansion and that our banks have helped to fuel with excessive loans, which we are now choosing to call performing loans when the truth of the matter is that they are not performing loans. The same goes for Poland. Look anywhere in the world where there's a crisis. Another way of looking at the crisis is that one dimension of it involves too much public sector expansion that the country is not willing to finance [by reducing] current consumption in the private sector. So, they're trying to have everything at once. And to me that is the nub of the problem that we're facing as we look around the world, both in international and domestic affairs. So, I see us getting into a different danger than the one that many of you are worried about and that is, through everything we're doing right now, the danger of monetizing excessive public consumption at home and abroad on a very large scale and using all these technical arguments as a way, in effect, to validate it. That to me is an equally great danger that is every bit on a par with the depression worry that worries all of us, especially the rest of you. It can lead to exactly the same place.

If I am right about this and it's the second danger that we ought to be focused on, then a year or a year-and-a-half from now there will be a tremendous fiscal stimulus plus the monetary stimulus that is now building up, not just here but on a global scale. We are talking about increasing the IMF [quotas] by 50 percent or 100 percent and pretending that all those loans are good, and forcing the banks to increase [their loans] by 5 to 10 percent. When I add all that up, that worries me. From the other side, we can create a further expansion of credit, which will blow up in our faces and leave us right at the place that we are worried about anyway. As I see it, when we stand back from all the technical issues we're dealing with here, we have to ask ourselves what we are doing as policymakers. We have to recognize that we can go wrong either way. And I think we're going wrong in the second direction right now.

It is with that background that I looked at this long paper, which comes to some interesting conclusions. My conclusion was that there is something wrong with every single measure. M1 has a few problems, as do most of the other [measures]. Nobody would argue that M1 is perfect. I surely wouldn't vote for it. But I don't think some of the other things mentioned, like credit or debt, are perfect as measures. Frank was for L for a while; then he abandoned that one and came up with debt. The problem for me with debt is not timeliness; if I were arguing Frank's case, I'd make the argument that if we made the same effort to get timely and comprehensive data on debt that we do on M1, M2, and M3, we could solve the timeliness part of it with less resources. But the question is the causality argument in terms of what is happening to the composition of debt. Let's not ignore the fact that there has been tremendous innovation in debt instruments and in composition of the debt, just as there has been on the liability side of the things we are talking about. And the view that the history there is any more relevant than the changing history of the M1 relationship, I just don't see, frankly.

So, my bottom line on this is that we should remember we can lose in either direction and the danger is that we will err on the side of monetizing public sector consumption that is excessive not just here but also abroad. If we do that, how will we know when we're doing that? I would say we ought to look at everything the market is trying to tell us, not just what Lindley Clark says or what others say. I have pages of them here, if you want to see them, and it's not just from one side. The bottom line of this one is that there is no doubt whatsoever that the Fed is inflating again; that pretty much summarizes what the market watchers are saying, whether or not they are right. But I'd complement that by looking not at what they say, but like everything in life, at what they do. Gold is up by $150 since June. Some of the commodity indexes are starting to turn up. The bond market is starting to get a little shaky on us. Many of you seem to think the dollar is automatically over-valued; I don't know that. If you take a look at all these things--what is happening to gold, to the commodities futures markets, to the bond market, to foreign exchange markets, and you see all those things start to look like the world is telling us we are going too far, we had better stop before we go too far down that track. And I think we're starting on that track. Therefore, my bottom line on all this is that, yes, we have to compromise some with M1, due to all its imperfections. But let's not err on the side of expansionism too long because we have already done a lot of expanding in terms of policy and we haven't yet waited to see what effects it will have. There's a long lag. We are looking at today's unemployment rate but doing things that will [not] be felt for months. And the actions we took a few months ago will show up hopefully in the first and second quarters, when I still think we are going to have some recovery, and I hope things will get better. Overall, that's how I see all this. And I hope these few comments will help some people to understand why I tend to be on the conservative side of this policy debate we are having. Thank you, Mr. Chairman.

CHAIRMAN VOLCKER. Well, we have time--it's 5:30 p.m.--for the two remaining names on my list, if their comments are not too long. Mr. Keehn.

MR. KEEHN. I will be brief. It seems to me, for all the reasons we've said, that we are going through a period of very high uncertainty. And during this transition period, while certainly we shouldn't abandon M1, I think we should deemphasize it considerably. I don't know how long it's going to take before we can re-utilize it, if in fact we can, in the way that we have in the past. But I agree with Governor Martin that the length of time required will be much longer rather than shorter. Certainly for the foreseeable future we should deemphasize it. It seems to me that we have pulled off this deemphasis of M1 pretty well; I am impressed by that. I think the markets have by and large accepted it to a greater degree than I expected. In all the public comments that you have made and everybody else has made we are putting greater emphasis on M2, which I would agree we should do, with a balanced view. And I think there is some considerable market expectation now that we will be following M2. The the very last thing we ought to do at this point is to introduce some new esoteric aggregate that we plan to follow, which could serve to confuse the markets. So, having introduced M2 in this way, I think we should carry through with it and use it as our principal guide. It also seems to me, in looking ahead, that we ought to be contemplating an increase in the range on M2 next year--in my view by a considerable amount. Meanwhile, we have an economy that is awfully sick in my view. We could very well be in a recovery phase. But the people I talk to, particularly on the industrial side, as I said earlier, continue to be very, very pessimistic. I think we should put a very heavy eye on interest rates, not only domestically but as they pertain internationally. We simply cannot at this point afford to have any increase in the rates we have some level of control over--mainly on the short-term side--for fear of the possibility that a recovery will be snuffed out. So, I'd be in favor of M2 but I also would be putting a very careful eye on following the interest rates.

CHAIRMAN VOLCKER. It falls to you, Governor Partee, to pronounce an interim blessing.

MR. PARTEE. Well, I actually agreed with a good deal of what Frank Morris had to say. First of all, I think it's clear that we have to have in mind the nominal GNP under the conditions of whatever time period we're looking at. And I guess that has a little something to do with what Bill Ford said. We don't want a really low nominal GNP because it might just take us right on down the hill. On the other hand, of course, we can't have too much monetary expansion over a period of time or it will affect the inflation rate over the longer run. Today, given 4 to 5 percent inflation, I suppose we ought to look for nominal GNP of about 9 percent, which would be 5 to 4 percent real growth. Now, I don't mean that we should target it, but we have to have it in mind; that really is what we're trying to get at any point in time. We have to have some linkage to the nominal GNP. Well, one linkage is transaction balances. And that, of course, is the old M1. I supported that [aggregate] for quite a while. But I really think it is badly damaged and is going to be badly damaged for quite a while. Even if, as Steve suggests, after the stock adjustment we get back to a place where two-thirds of M1 is transactions money, one-third of it won't be. And that one-third will always have a considerable potential for movement that will muddy what is happening in the transaction relationship between what we're doing with money and the nominal GNP that we really would like to see over a period of time ahead. The other connective that I can see is credit. It seems to me that credit flows are very closely related to the performance of GNP some time out. I agree with Frank in that I don't see this causality argument running any more against credit than it does against money. It's just the way people look at things that makes them say it in the one case and not in the other. My problem is that I just don't think we are prepared to go to credit. We don't have the background work done. We don't have the figures and we don't know what the behavioral characteristics are; and, therefore, we can't do it now. But I hope we will do it in the period to come. "L" adjusted actually is the best figure in the set of tables, Paul. That's an interesting thing. Adjusted "L" is the best result.

CHAIRMAN VOLCKER. Just the [Divisia L].

MR. PARTEE. The [Divisia] adjusted "L," which is--

MR. BOEHNE. How would you like to explain that?

MR. PARTEE. I just point out that it has the best record; it's better than the rest. But it does suggest that it may be a fairly complicated relationship. The thing that bothers me about M2 and always has bothered me about M2 is that I really don't see how we can affect it very much other than through affecting the economy. If M2 were running high, would you raise interest rates or lower interest rates to get it down? I'm not really quite sure what direction we would want to move unless one says M1 is running too high and that means the economy is going to be too strong and, therefore, we want to raise interest rates in order to reduce income flows and that will lower M2. One might say that, but that's a different thing to say than that we are targeting on M2. It's obviously reflective of the economy. Well, I agree that we have to use M2, which I think instinctively is the wrong thing, but it's the only thing available to us now. And I would agree with Lyle that we certainly want to be very flexible in the way we do it because we have very little way of knowing what the number is likely to be; and then seeing what it is, we have very little capability of influencing it. So, we better have a wide range.

VICE CHAIRMAN SOLOMON. You have a complete consensus on action if not on--

CHAIRMAN VOLCKER. Well, we will resume tomorrow morning.

[Meeting recessed]

December 21, 1982--Morning Session

CHAIRMAN VOLCKER. We can come to order. I think we can proceed with the conversation we were having yesterday evening, if additional people want to say something. I have two names staring at me here. I presume that they indicated that they wanted to add to our discussion. Governor Teeters.

MS. TEETERS. I want also to congratulate the staff on a very thoughtful paper. I've read and listened very carefully over the past couple of days and, quite frankly, I think we're back to being as close to "the feel and tone of the market" as we've been in thirty years. The relationship, I think, is to nominal GNP and its composition, not just to total GNP. But we want the right relationship between real growth and inflation. As I see it, we basically have three instruments of policy. One is reserve requirements, and that line to M1 has become even more muddy; it never was very good because we never fully got through the phasing in of the Monetary Control Act. And now we have an instrument that doesn't have [comprehensive] reserve requirements on it. The [reserves] link to M2 is very tenuous and it's getting worse. It may well be that the multiplier adjustments will become the major instrument in the determination of policy, in terms of actually carrying it out or trying to figure out what we're doing. The other instrument we have is the discount rate, which we can move at the recommendation [of a Reserve Bank]. And finally, it's the provision of reserves either directly through the open market or through [discount window] borrowings. And through this we get to money, credit, and interest rates one way or another. We can do it a number of different ways, and we have done it different ways over the years. The problem is how to determine the amount of reserves we're going to put into the system. Those normal historical relationships that we've been used to have become disconnected. We don't have a stable demand for money anymore and we have a history of changing velocity this year. Even abstracting from the financial innovation, those relationships aren't very good. And if we add the innovation, they get worse. As I see it, we used M1 targeting as a means of performing traditional monetary [policy] functions, which was basically to help engineer a recession in order to slow down inflation. In fact, what we've done is almost classical. We sort of hid behind M1, but that is what we accomplished one way or another.

It seems to me that what we need to do now is equally traditional and that is to get interest rates down low enough to get some real growth going in this economy. I don't really care what we call it--whether we call it targeting on M1 or whether we have broad interest rate targets or something of that sort. I'm perfectly willing to go along and pay lip service to targets if that's going to get us out of this box. Fortunately or unfortunately, for at least the next six months, nobody is going to know what to do anyway. They won't even know whether we're hitting the targets, given all the money that is moving around out there. So, when I thought through my policy goals, at least for the next three months and possibly for the next six months, I concluded that what I want is a federal funds rate in the 6 to 8 percent range and borrowings at the frictional level. I leave it to the staff to tell me what rate of growth in M2 will get me those two objectives.

CHAIRMAN VOLCKER. Speaking of prices, let me just interject in case you haven't heard it: The consumer price index seasonally adjusted rose 0.1 percent in November. It's as low as it is primarily because of declining mortgage interest rates. Governor Rice.

MR. RICE. Thank you, Mr. Chairman. I also would like to compliment the staff on an excellent paper, which was done under a great pressure of time. I happen to know when they started to work on it, and I think it was an excellent job all things considered. Like Governor Teeters, I listened carefully yesterday. And while I have no new insights as to how to deal with our problems, that was not your fault. The discussion was an interesting one and helpful to me. I do have some reactions and one main point I'd like to make, if I could. But first where I come out: I would join the emerging consensus and support the targeting of M2 at least over the transition period. Regardless of how one feels about the feasibility of targeting the aggregates in the long run, this is not the time to abandon targeting on a monetary aggregate, given the concern that already has emerged in the financial markets as to the Federal Reserve's determination to continue to restrain inflation. So at least for the next few months, and possibly even beyond the transition period--depending on how M2 behaves--I would certainly support the consensus that seems to be emerging. I would also agree with Bob Black that we should make every effort to shift adjust M2. I would not like to make a commitment at this time to rehabilitate M1 after the transition period has passed. While M1 may prove to have the desired behavioral characteristics, it will take some time, as Frank Morris has pointed out, before we can determine that it does have these characteristics. M1, as pointed out by Mr. Axilrod, will be a new kind of animal and will have to be observed for some time.

Like some others around the table, I share some sympathy for President Morris' debt proxy and I think it certainly deserves further study. The problem with it now, from my point of view, is its controllability. I'm sure Frank would say: "What about our luck in controlling the monetary aggregates?" I guess I would have to say that we believe we can control the monetary aggregates, even if we don't. At any rate, at this time there are control problems. I don't know how we would get total debt to perform as we would like it to. And, of course, the practical problem is the one pointed out by Governor Partee. The fact is that we don't have the background yet [to target debt]. But, as I said, I would urge further study to determine the feasibility of targeting on debt or some broad liquidity measure. Now, after the transition period, if M2 does not turn out to be a satisfactory target objective, I think we are in some difficulty. We may well have to become more eclectic than we anticipate.

I'd just like to say--and this is the main point that I want to make--that I don't agree that the only objective forever and for all time of central bank monetary policy is to keep prices down, to restrain inflation. It seems to me, depending on the circumstances, that the primary objective of central bank policy could be maintaining a steady non-inflationary rate of growth. Or in other circumstances, for example with prolonged stagnation, [high] unemployment, and under-utilization of capacity, it might well be to promote recovery. It seems to me that the primary objective of central bank policy has something to do with the most feasible option with regard to targeting. It may be, and I suspect is the case, that if the primary objective is controlling inflation, control of the monetary aggregates might well be the most feasible object of our targets. It may well be if our objective is maintaining a steady non-inflationary rate of growth that we would want to target on short-term interest rates. And if we're trying to promote recovery from prolonged stagnation, it may well be that some variant of the debt proxy or perhaps targeting directly on GNP would be the most feasible road to take.

And with regard to targeting on GNP, I don't agree that one is playing God when one undertakes to probe for a rate of real growth that is non-inflationary. I think it makes perfectly good scientific sense to try to find such a rate in an economy at any given time. So, we may have some difficult choices to make with respect to monetary targeting or other options beyond the transition period. I would simply urge that we maintain a certain open-mindedness or flexibility, if you will, as we live from Federal Open Market Committee meeting to Federal Open Market Committee meeting. Hopefully, in time, the right option will emerge clearly. Thank you, Mr. Chairman.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. Well, although we all believe in controlling the money supply over the long run, some of us are placing importance on returning to targeting M1 as soon as possible--say, by the middle of next year--and some of us are more skeptical. I don't think that creates a problem in the Humphrey-Hawkins testimony; it's perfectly finessible. [We should say] that we will be watching it and learning from it what we can, notwithstanding distortions, and that if we see that it becomes free of distortions, it could be an appropriate target. I think there's a widespread feeling of uneasiness among us about M2 and M3 as presently constituted. They don't have a track record; we don't know what they tell us about nominal GNP. One thing that bothers me is this: Suppose next year or the year after we begin to see inflationary pressures develop and we have to start tightening. If M2 and M3 were growing weakly and unemployment were over 10 percent, what is our reason for tightening? What do we offer? I feel that the fig leaf is pretty much tattered and that the mood of the Congress is pretty realistic. The country knows what we are doing and, therefore, that we have an important effect on economic activity as well as inflation. It seems that there ought to be a way of formulating our policy so that it meets the political realities and is a little more honest, and yet doesn't lock us into the bind that we all are familiar with. Therefore, I would recommend for serious consideration that we say the following: That we have certain expectations about where M2 and M3 will end up--and perhaps avoid the use of the word targeting; that those expectations would be importantly influenced by trends and levels of real economic activity and trends and levels of inflation; and that we would be drawing our reserve paths from M2 and M3 as we go along with the meetings. But I'd be fairly honest about the fact that we're looking very heavily as well at other considerations that are less important, such as nominal GNP and the exchange rate. Those would be the two important ones. I would add to that, just as reassurance to the markets, that our long-term policy, notwithstanding any possible alternate later weakness in the Ms, would be to maintain positive real interest rates.

SPEAKER(?). To do what, Tony?

VICE CHAIRMAN SOLOMON. To maintain positive real interest rates is our long-run policy. I think it's important to reassure the markets. There are various ways of formulating that. We don't have to use the term real interest rates, if that's thought to be objectionable. We can talk about the levels of prevailing interest rates in relation to inflation. We don't have to get into the expectations area; we can take the [unintelligible] version of what people mean by that. I would have no objection to substituting for bank credit, which is a very narrow debt measure--as an associated range, not as a target--total nonfinancial debt. Again, I think that shows a certain amount of responsiveness and flexibility on our side and it is fairly realistic. I don't see that it would do any damage. It could be a monthly announcement but it probably would be a quarterly announcement if the staff and the Chairman felt that they didn't want to do that much estimating and wanted to wait for harder data.

MR. PARTEE. We don't have a monthly series now.

VICE CHAIRMAN SOLOMON. That's right; I'm aware of that. They could, as Steve said, get it out with some heavy estimating in maybe three weeks after the end of the period. But if we didn't want to do that, then it could be a quarterly announcement.

There is one last comment I wanted to make and that is that a couple of people commented that they think we ought to do a shift adjustment of M2. Even though privately the staff will certainly be trying to analyze the movements of M2, I don't see the desirability of calculating a shift adjustment for announcement purposes. I think it's much too dangerous. And I don't think it gains us that much. That's all.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. I think M1 has served us well and, indeed, its being linked by theory to our ultimate objectives in the income and price areas makes it very attractive. So I'm distressed that for now and the foreseeable future it will not serve us as a reliable rule. I agree that M2 is what we should be focusing on in the intermediate period. The question, of course, then remains how to control it, which has been discussed at some length. But I do think we need to have enough control over it that it really is a rule and not just a discussion point for the Committee. How do we assure the world that we're still in business? I lean toward having the Chairman make a statement that, while it may be premature to commit to returning to M1 at a particular time or perhaps to commit to returning to M1 at all, as soon as possible we would look to return to M1 when experience has accumulated that would enable us to use it again. I felt [some sympathy] with Bill Ford's reasoning yesterday that there are dangers on one side of collapse and on the other of monetizing the debt. That that would lead us to looking at other indications of what our policy is accomplishing made some sense to me. On one side we could look at nonborrowed reserves or the nonborrowed base; on the other side we could look at the price of gold and long-term bond markets and things that are linked by expectations of future inflation. The exchange rate suggestion also, I thought, was a very good one. The danger in this, of course, is that we gain too much flexibility and don't have the self-discipline of having a rule. Nonetheless, we aren't in normal times and looking broadly at a number of other financial numbers in addition to M2 is perhaps called for. My concern remains that, once the economy does pick up, we must make some difficult decisions about what the future course of the economy should be and perhaps effect a change in monetary policy in that we will be facing a situation with a federal deficit that will not decline adequately to make up for the pickup in the economy. And M2 is a difficult aggregate to control at that point. But for the foreseeable future, I agree with the consensus that M2 is what we should be working with.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. I also would agree with the consensus that M2 is probably about the best we can do. I'm not ready to concede that M1 will no longer be viable. On whether to commit to returning to M1, I guess I would like to; but realistically that might be slightly premature. I would couch it in terms of a presumption of returning to M1 if that proved feasible as we gain more experience. In terms of the public's perception, it does seem to me that the explanation that you gave in October of what we were doing could carry forward right into February. We will place less emphasis on M1 and more emphasis on M2, with the explanation of the institutional changes that are taking place and have been discussed. That's all people read about. I think it's pretty understandable. I think a consistent story, much along the lines of what we used in October, would carry us through at least until midyear.

CHAIRMAN VOLCKER. Any other comments? I don't know quite how one summarizes this discussion. In some ways I think there was a consensus; in other ways I think there was a lot of disparity. Let me make a comment about the deficit that has emerged from the discussion this morning. I don't think there is much prospect of the deficit declining in any foreseeable time period, which is a more important problem maybe than some of the ones we've been grappling with in the last couple of days, difficult as those are. The Administration's current estimates are going to be higher than anything we've seen and will remain higher. I think we have to have targets, just by law. And apart from the law, I didn't notice any great tendency around the table to depart from them entirely in terms of monetary or credit targets.

VICE CHAIRMAN SOLOMON. Does the law use the word "targets" or the words "plans and expectations"?

CHAIRMAN VOLCKER. It says "growth ranges." I was about to say that we may want to deemphasize to some degree the word "targets." That may be impossible to do; we've used it so frequently. I take note of what you have said, but certainly the consensus I hear around the table is that we can't interpret this so rigidly in terms of what is going on currently and prospectively. There was a good deal of feeling that of all these numbers M2 probably deserves the most emphasis at the moment, but there are a lot of qualifications surrounding that, I recognize. I don't think the M1 question is an "either/or" question. I don't particularly ignore it even today. Its significance may [involve] a much wider range, but if M1 hadn't been rising as rapidly as it was rising in the last six weeks, we presumably would have had an easier policy in some sense. Even now we can't make out what is behind it; but it gives a lot of people, including me, a little pause when it is rising that fast even if it's not a formal target. And that does to some degree influence what we are doing. So, there's a recognition that I wouldn't say [in my testimony that] we will ignore M1; but it can't have the formal role that it had for some time anyway. I'd leave open the question of when and how we can return to it.

As for the total credit measure, I had this interchange with Mr. Reuss and said I would put to you more or less formally whether we would include it. I don't know that I used the word target; I don't think I did. Whatever I said was heavily qualified, but I said we would consider presenting some kind of number for total credit. I'm not sure everybody agreed with that, but unless I hear some objections, I take it we will present some numbers for total credit at the very least on an experimental basis. Exactly which series, how frequently, and all the rest, we'll have to look at. But we will put some kind of benchmark in there unless you tell me otherwise. It certainly won't be emphasized as a target, in capital letters, but as something we observe and which may have an influence on us. I'm not sure that we want to control any of these [aggregates] all that closely, given the degree of uncertainty that exists and those velocity numbers recently. It seems to me that the direction of these signals is clear enough if they are all going in the same direction. If we get mixed directions, then we have a different problem. But if credit growth is high, M2 is high, M1 is high, and M3 is high, or vice versa, we know the direction in which we want to lean. How much tolerance we have and whether we say we're going to hit that target, with a capital "T," and all the rest is another question. But it gives us information about the direction in which we would want to go. From that standpoint, if we don't have those targets in capital "Ts" in quite the same way [we used to], I'm not sure that the control issue and just how interest-elastic they are and all the rest are necessarily that much of a problem. That's my reaction; other people may have different reactions.

I do think we're going to be forced into a more explicit rationale, whatever we do, in terms of the nominal GNP. I'm not saying we have to target nominal GNP very directly, and there are obviously dangers in that, but I do suspect that we're going to be drawn out on that subject much more heavily than we have been in the past. I think there is a real danger in that because it does overemphasize what we in practice can do. I think there's great overemphasis now on what monetary policy can do either in terms of nominal GNP or interest rates. And it's very dangerous. It's partly just a matter of frustration. Nobody else can think of anything else to do so they say that the monetary authority must have control over all these things and if they press the right button everything is going to come out right. The presumption is that there's a right button to press; I'm not sure there is. Some problems don't have that simple an answer. I suspect we're in one of those periods, and we ought to devote some attention to arguing that we're not all that omnipotent. I myself would accept what some people have mentioned: That we keep an eye on such things as exchange rates or maybe even more importantly the price trend and the price forecast but that we not formally target them.

I wonder whether we need another meeting. I think there is enough convergence so that we don't need it for this purpose. I suspect that we may have a telephone meeting anyway sometime between now and February just in terms of current policy, and some of these issues might be raised. Perhaps Steve Axilrod can send out some kind of format or framework as a basis for a discussion of some of these things. I'm not worried so much about what the precise numbers are but about the framework that we might use to present it and to help focus the discussion in February. I'd do that considerably before the meeting and maybe even before a telephone meeting so that we can get any comments on it and see whether we're talking about the right framework when we come back in February with some language about how much emphasis, what these numbers mean, and some preliminary paragraphs--I guess it's not a directive when we present these annual targets--we might write in terms of presenting the annual numbers. We will see whether we can come to some kind of conclusion about the way we want to present this and we will focus more at the next meeting on what numbers we want to put in there or what modifications in the language we want. On balance, I think we're left with what could be termed an eclectic, pragmatic approach. It's going to involve some judgment as to which one of these measures we emphasize, or we may shift from time to time. And if they move in diverging directions, we're going to have to make some judgments as to which one is more significant at any particular point in time against what nominal GNP is or what the goal is or what the real economy is doing and what prices are doing and all the rest. I just don't see much alternative to it. From one point of view it's not the worst thing in the world; that's the way the Federal Reserve used to operate, less elaborately, for years when policy by present standards looked pretty good.

MR. BALLES. We seem to make our mistakes scientifically now!

CHAIRMAN VOLCKER. That's right. We may make bigger ones that way. In today's world, with things so uncertain and upset, it does have dangers. It personalizes things much more, which I don't think is ideal. It leaves us with more expectational questions. It may be fine now, but everybody will say: What happens when the Board changes and the personalities change and you don't have a rule? But I'm hard pressed to condense what we have to do into a simple rule, given all the uncertainties we face and given some of these numbers going off track. I don't think we have to apologize for the approach, but I don't think it's ideal. There was some question--Roger Guffey and some others may have touched upon it a little--of explicit interest rate targeting. I don't think we have to go to that. It's a fine distinction maybe, but there is a distinction between having an explicit interest rate target and having, as I'm sure a lot of people do around this table, some limits of tolerance on what interest rate change one wants and some general idea as to the direction one would like rates to go as one is interpreting the numbers and setting the targets and setting the borrowing levels and so forth. And I think it's a distinction worth preserving. I'm not sure I'd want to confine myself to talking about real interest rates or saying we have to have a positive real interest rate. I can imagine circumstances in which we might have to have a negative real interest rate. I don't think we anticipate it at the moment, but I'm not sure we want to have too much at stake on a real interest rate.

There was one thing I do disagree with, so I will just state it. There was some implication and some comment that people would be perfectly happy with even bigger swings in interest rates--I may be overstating it--in order to keep some of these aggregates on target. That, I think, we cannot afford in the foreseeable future; I just don't think we can. We have had too much [rate fluctuation] in the past for my own blood. But given the state of the economy now I do not think we can be casual about thinking of swings in interest rates of several percentage points up or down and just take that as a by-product of some target we're aiming at that we've not very sure of anyway. That is one thing I would feel pretty strongly about myself.

VICE CHAIRMAN SOLOMON. I agree with you on large swings, but there is some disadvantage in being tied as closely as we are to the discount rate and not having any fluctuation of even, say, 50 basis points.

CHAIRMAN VOLCKER. Oh, I'm not saying anything like that. I'm not sure we're tied that closely to the discount rate.

VICE CHAIRMAN SOLOMON. Well, that's the way it seems to be working out.

CHAIRMAN VOLCKER. All right, maybe during this period. But I'm saying I don't think there's any implication of that at all.

VICE CHAIRMAN SOLOMON. Well, if borrowing stays as low as it is, it leaves--

CHAIRMAN VOLCKER. It's because it has been a by-product of borrowing being fairly stable. But that's a decision we can make all the time, right? No, I'm talking about swings of several percentage points in an effort to get something back on target promptly.

MR. PARTEE. It would take at least that on M2.

MR. FORD. I'm wondering who is in favor of bigger swings in interest rates than we've had. I didn't hear anybody say that.

CHAIRMAN VOLCKER. Well, I may be hearing things that weren't said. I don't think so, entirely. It's not a question of being in favor of it, but I interpreted some comments as saying that if being less sensitive to interest rate movements is a necessary expense of staying on target, that's okay; we just move the interest rates more. I thought I heard some people saying that, but maybe not.

MR. ROOS. How would what you just described really differ from the 1977 to 1979 eclectic/pragmatic approach? I don't ask this in a critical vein, but does this all add up to conducting policy as we did prior to the need for shifting gears in 1979? Are we, in effect, going back to looking at a whole lot of things and using our intuition?

CHAIRMAN VOLCKER. Well, to oversimplify, I don't think it bears much relationship myself to the particular period that you're talking about. If I wanted to make a comparison I'd go back longer than that; I would go back to, say, the early 1960s. I think it's much more elaborate than what was done then because we are looking at indicators much more explicitly. But it you look at enough indicators, it does get a bit eclectic. There's no question about it. And I don't think we ought to apologize for that. I think that's the way the world is at the moment, but it has some disadvantages. It would be nicer, from a number of perspectives, if we had a simple, clean-cut rule. I just don't see what that clean-cut rule is for the next six months or year anyway. And I think that's what I hear around the table, too.

MR. ROOS. But it does have a reinflationary potential, doesn't it? Again, I'm not being critical, but isn't this fraught with danger in that regard?

MR. GRAMLEY. It could easily have a deflationary potential. It depends on how the judgments work out.

CHAIRMAN VOLCKER. I think what you might be saying, Larry, which a number of people have said--and I have great sympathy--is that the value of these rules is to discipline ourselves as much as anything. And if there are too many things to look at, one can always find some way to avoid that discipline. I guess we just have to appeal more to our internal discipline, but I think that is one of the things we have to lose. I don't want to overemphasize the difference, but very broadly I would say we were willing to emphasize some of these things so much because we were preoccupied with that need for disciplining ourselves and disciplining the economy. We were willing to accept a lot of guff, if that's the right word, and a lot of potential side effects because [the goal] was all important. It's still very important but the risks have shifted. We have made some progress on inflation; we got it turned around. It's very important that we maintain that, but can we use such a simple rule as we have been using when the relationships between the rule and the economy, which never were all that great, have broken down at the moment? So, we have to look at one to one. I don't think I am saying anything very different from what I heard around the table.

MR. WALLICH. We seem to be talking about the difference between the proviso and the rule. We've switched from this in the past, as you know. We had an interest rate rule provided the aggregates or reserves didn't violate some constraint; then we moved the other way. We had a money supply rule provided the funds rate didn't violate some constraint. I think we're somewhat in this area here. There is a difference in saying we have an M2 target, which we qualify by a number of other things, and saying we are looking at a lot of things but we hope that M2 or some other monetary target comes out right and we will try to effectuate that. There is a difference even though the two [approaches] meet somewhere in the middle.

CHAIRMAN VOLCKER. That's what we need a framework for. What I think I hear, which I don't disagree with at all, is that the central target in some sense is probably going to be M2 for the moment. But that is going to be more qualified than the way we have presented these targets in the past for two reasons. One is that we don't know what institutional impact there is on M2 and we have to qualify it for that reason whether or not we can in some sense formally measure the shift adjustment. We are going to have to have at least an informal shift adjustment. But that's not the only problem. We also have velocity going off the trolley with M2 as well as with these other aggregates. So, M2 is the central target--I guess that's the right term to use--but it's a somewhat more qualified target than we've had before. What I think we're groping for is how to state that M2 is the central target but we also are going to be looking at these other things. One way is a kind of proviso--I don't know what formal language we would use--that if these other things are going off in a different direction, we will evaluate M2 in the light of credit declining or rising or whatever or if M1 for that matter goes way outside some range we would explicitly [take that into account]. I find M1 rather inexplicable in November, not in October; the November behavior worries me and it's continuing into December. Maybe it will all wash out with this new account; it may wash out to a considerable degree or not all. So, we will wait and see. If it doesn't, that worries me. As I said, I think we're tighter than we would otherwise have been if that had not been going on.

MR. FORD. May I ask what worries you about M1 in November? I, too, noticed that the amount of change in M1 went way beyond anything we were looking at in terms of all savers certificates, and there was some thought that the [maturing] all savers certificates would give it pop and then would phase out. But the fact is it's more than that.

CHAIRMAN VOLCKER. I would have expected the bulge we got in October in part because of all savers. But all savers maturities were not that large in November, and I would have thought that after a month or so some of that money would be moving into other investment vehicles. An argument is that there are other things going on too. One argument is that everybody, or a substantial number of people, is sitting there waiting for this new account. So that continues to have an influence. Who knows? Maybe we'll get a little more insight when we get the numbers on the new account, but we haven't gotten them yet. That's all I mean: I would have expected the all savers impact on M1 in November to be rather sluggish, and it wasn't.

MR. PARTEE. It could be temporary; it's hard to say.

MR. FORD. It's worrisome. It's well beyond what we were talking about.

MR. PARTEE. It could wash out in the period right ahead.

CHAIRMAN VOLCKER. I think we have the other problem that Frank Morris keeps talking about. We seem to have assumed that the NOW account phenomenon was damped to the point of being nonsignificant in terms of shifts this year, and maybe it wasn't, particularly as interest rates came down and got more competitive with the NOW account interest rate. If you look at the old M1, we had a very restrictive policy; even with the old M1-A, we had a very restrictive policy this year until just recently. Now, that has begun rising in the last two months, too, but in the early part of the year it did nothing.

MR. FORD. May I ask your perception on one other thing you said? You mentioned that you feel we are not managing interest rates. But when you just look at a chart of daily deviations in the fed funds rate and actually measure the variance on a daily basis before and after October--

CHAIRMAN VOLCKER. Targeting interest rates. Targeting interest rates.

MR. FORD. If you talk to people on the street that I talk to, they are saying that we are not only managing interest rates but are steadily pushing them down and reducing the deviation and that that is our policy. That's something I hear. I would like to ask Tony or you whether you hear or sense any of that and whether or not you feel there is some element of truth that that is what we're doing.

CHAIRMAN VOLCKER. Well, it's the other side of the coin. We have been more tolerant of changes in the aggregates, I suppose, and haven't reacted all that strongly, and that smooths out interest rates. But that's different, I think, than targeting on interest rates. I don't consider it a bad thing that interest rates are more stable. I think that's devoutly [to be hoped for]. If we can do it consistent with the other things we want to achieve, great. If anything, this fluctuation in interest rates for the past few years to me is very broadly a reflection of the sickness of the economy and the financial system. It's not a normal thing to have interest rates bouncing around like that. They don't in other countries, by and large; they never used to here. It is something we may tolerate in an effort to achieve a larger objective but it is of no merit in and of itself, in my view.

MR. FORD. I certainly don't like those wild swings in rates. Looking back, there's an obvious difference of opinion as to what caused that. Some people would say that the very fact that we never did stabilize either the base growth or the M1 growth may be what caused the fluctuations, which nobody liked, including me. But looking ahead, I get the feeling that we are being perceived as very tightly managing day-to-day short-term rates and that the market is looking at us that way. I wonder if my perception is wrong. Tony, what do you think? Is the market thinking that or not?

VICE CHAIRMAN SOLOMON. Well, the market thinks there has been a definite change in policy. But I would say the majority of players think that what we have been doing is justified. There is a technical disadvantage in being caught in a situation where the borrowing level is so low. We don't want to tighten the nonborrowed reserve path because we don't want to see interest rates climb up and, therefore, in practice the only way interest rates move down is via a discount rate cut. That's a more technical consideration and maybe it's only short term; I don't know. But I don't think the market or other people are faulting us one way or another for pegging an interest rate. I don't think that it has gotten to a point where they think we are pegging in a targeting sense. If the fed funds rate doesn't move more than 20 basis points or so except with a discount rate cut and that continues over a period of many months, then I think there will be an increasing feeling in the market that we, in effect--no matter what we say--are actually pegging in a targeting sense.

CHAIRMAN VOLCKER. The irony is that short-term rates have been fairly steady since September while we have reduced the discount rate about three times. The bill rate is now slightly higher than it was in the middle of September.

MR. PARTEE. But Tony is right. The discount rate and the funds rate have been closely linked.

CHAIRMAN VOLCKER. They are bound to be when we are operating in a fairly narrow band of nonborrowed reserves.

MR. PARTEE. Paul, do I understand that we have been asked to give more of a Committee forecast with the GNP and associated numbers like real GNP and--

CHAIRMAN VOLCKER. Well, what I understand is that we were asked to give a Committee or a Board forecast.

MR. PARTEE. Well, which was it: Committee or Board?

CHAIRMAN VOLCKER. I don't know whether it was that explicit. But whichever way it was, it was refused. They were told that we would give the same ranges that we gave before with an addition, maybe. I said more than maybe, I guess, but it wasn't absolutely a promise. I said we would explore the feasibility, particularly if the distribution was not symmetrical, of giving some indication of where the central tendency of the individual forecasts lay. But it was not a Committee forecast and it was not a Federal Reserve forecast and it would not be a Federal Reserve forecast, in capital letters. It would be a somewhat clearer description of where the mode of the individual forecasts was. And that's all it has been.

MR. PARTEE. Well, it does tend in the direction of suggesting that in order to make the forecast we need to know what policy is going to be. And yet if I understand it, the way it has worked before is that we have made a forecast before the meeting. I see a procedural problem with that.

CHAIRMAN VOLCKER. I think the forecast is going to take a little more care this time than before. I don't know whether we all make the same assumption on monetary policy or not, but the thought occurred to me.

MR. BOEHNE. We'll have to have a preliminary forecast and then have a discussion about that.

MR. PARTEE. That would probably be the way to go.

CHAIRMAN VOLCKER. There's no question. My assumption is that we'll at least need to have some chance after the preliminary forecast for individuals to relook at their forecasts on the basis of whatever they want to consider. Whether we should force [the individual forecasts] into a common monetary policy assumption I am not sure, particularly if policy is going to be [vaguer] in some way or another about what the targets are. If we say we may change the targets during the year, every individual Committee member may have a different idea of how that may be changed.

MR. PARTEE. But in the end we're going to be stating a Committee stance on monetary policy. And they naturally will expect even as individual forecasts that they will be associated with the Committee's stance on monetary policy, I think.

CHAIRMAN VOLCKER. Well, when you say stance, that's probably unavoidable. Whether it is associated with a precise monetary number, though, is something else again.

MR. PARTEE. All right. Well, that's why I said stance. We have to avoid the word target.

CHAIRMAN VOLCKER. That's correct. We make the distinction between stance and [target]. We will have to think about just how we will do it, but I suspect we're going to need two rounds of forecasts anyway.

MR. CORRIGAN. I think what a lot of this discussion really comes down to is that we're looking for some kind of steering mechanism that we can in some sense advertise as a target. Much of the discussion has gravitated toward M2 as being put in the role of the primary steering mechanism or the primary target, and that's where I started out. But I'm having some second thoughts even about that. I would at least raise the question of whether we aren't underplaying M3 too much, by inference. Normally, I would never say that. But if you think about M3 in 1983, quantifiably it is going to be less subject to shifts than even M2. If you look at it in the post Regulation Q disintermediation period, in fact it has really been quite stable. Whatever the relationship between any of these aggregates and GNP might be, the relationship between M3 in this period is also less susceptible to change certainly than M2 or M1. And of course it is so vague that it inherently provides us with more flexibility in terms of short-run operations and avoiding the tendency of stepping on interest rates too aggressively. So, I would just like to suggest that in all this we not lose sight of some potential advantages that there may be in M3, particularly from a communications point of view.

MR. RICE. How much weight would you give it vis-a-vis M2?

MR. CORRIGAN. Well, at least equal weight with what I hear people giving to M2 right now.

MR. ROOS. Jerry, how would you control it?

MR. CORRIGAN. Well, that's the problem, though I don't see any difference conceptually between controlling M2 and M3. As a matter of fact in this period with all these shifts and things, I would guess that M3 will be easier to control because the multiplier effects from the deposit shifts can wash each other out more in M3 than in M2. I don't minimize that problem. Intuitively, I think it might be less of a problem with M3 than M2.

MR. PARTEE. It may be more stable, but I don't think it's more controllable.

MR. CORRIGAN. I don't think it's more controllable either, but I don't really care about that; it's not less controllable.

SPEAKER(?). That's right.

MR. PARTEE. I don't think we can control Eurodollar deposits.

MR. CORRIGAN. But I don't think it's less controllable. I think Frank is right.

MR. AXILROD. We would put the Eurodollar deposits in if we could get them on time and we're trying to get them on time.

MR. PARTEE. Well, I mean on a net basis. Isn't it true, for example, that M3 growth has greatly exceeded bank credit expansion recently and that's because banks have been financing their foreign branches? If that reverses, M3 growth would be much smaller than bank credit expansion because banks would be bringing money back from the branches. That kind of thing would be a new dimension and it is of some importance.

MR. CORRIGAN. No, I concede that.

CHAIRMAN VOLCKER. We don't have great definitions of any of these Ms.

MR. MORRIS. I think Jerry is right. The most scientific statement made yesterday was Lyle Gramley's statement that the staff estimates of the impact of the new account on M2 are off the wall. And I think that's exactly right. As long as the banks are paying an above-market rate on the new instrument--and I don't know how long that's going to go on--there is a tremendous incentive to shift out of market instruments into M2. At least with M3 there is the offset in that presumably the banks that take in a lot of money this way will be taking in less through large CDs. I would differ with Jerry only to the extent that I wouldn't have an M2 target at all.

CHAIRMAN VOLCKER. Well, we're not going to resolve any of these issues today. I think all we can do is send around a preliminary framework, as I said. And if we want to have another meeting in January, we can. I don't know if anybody else has that feeling, but I don't think we ought to do this before getting some kind of framework.

MR. CORRIGAN. Could I ask one other quick question?

CHAIRMAN VOLCKER. I'm not sure.

VICE CHAIRMAN SOLOMON. One more, as Cagney says.

MR. CORRIGAN. If we are going to report this central tendency in some way or other, do you contemplate that in any explicit way you would try to draw, however gingerly, a connection between departures from the performance of the economy vis-a-vis the central tendency in terms of what we would be looking for in M2 or M3?

CHAIRMAN VOLCKER. I'm not quite sure what you have in mind.

MR. CORRIGAN. Just a simple case: Assume that we have not only a central tendency but a tremendous convergence that says nominal GNP is going to grow by 9 percent; prices will rise by 4 percent and real GNP by 5 percent to make it nice. Then we say we think M2 and M3 and total credit will look like X, Y, and Z. But then this central tendency [puts our forecasts] in a different light than the old forecasts if, as we get into the year, there's a marked departure in actual performance of the economy from the central tendency even though the Ms and whatever else we use in our steering devices look all right. The question is: Do you contemplate any more of a direct linkage between what we would do with the steering devices or targets and that central tendency forecast?

CHAIRMAN VOLCKER. Well, I'm not sure; my instinctive answer would be that I'd try not to make the central tendency all that prominent in terms of what is desirable. But I think we are going to be forced into precisely what you are saying, after some statement. It probably will be viewed more against the Administration forecast or some congressional forecast. They will say: We think a minimum adequate growth is X and if it's below that, are you going to ease?. And if X is low enough, our answer might have to be yes. I don't know how to state it or fuzz that up, but at some point that's precisely what I would expect to happen.

MR. WALLICH. I might have to state the associated increase in inflation.

CHAIRMAN VOLCKER. Well, you can't tell. Suppose after all the different permutations and combinations, the inflation rate is high and the real growth rate is low; we'd have a different answer than if real growth is low and inflation is low. One can [consider] any other combination of those. I'd try to talk my way around it. I think the Administration is going to have a low real [GNP forecast], as a matter of fact, because Mr. Feldstein is so preoccupied with not overestimating. But where I'm a little afraid of getting trapped is this: If they have high inflation and high real growth and the Congress says that's just fine, we're glad to live with 5 or 6 percent inflation and we want 5 percent real growth--that's not what the forecast is going to be but suppose it were--we would say that's much too much inflation and we're satisfied with much less real growth. Then we'd have a real problem, I think.

MR. PARTEE. Yes, if we get a high nominal, then we really have trouble. However it adds up, 11 or 12 percent is a problem.

CHAIRMAN VOLCKER. I could picture that the happy staff optimism on inflation is right and it is coming in around [their forecast], but the real growth isn't doing very well. They might say: My word, you're doing much better on inflation than you're supposed to be doing in some sense and you're not doing very well on real growth, so you obviously have to ease up. That, I think, is going to be a big problem. And it's going to be more so in that connection [depending on] what we say is the central tendency.

MR. CORRIGAN. That reason, as well as the ones I mentioned earlier, led me in the direction of thinking a little more about M3 because I think it will give us more flexibility.

VICE CHAIRMAN SOLOMON. But if we assume that our annual targets on M2 and M3--assuming some velocity of circulation we can defend--are compatible with the Administration's forecast of nominal GNP, which I think they are likely to be, we still would want to say that in setting quarterly targets for M2 and M3, we would be looking at the trends and levels of activity and trends and levels of prices. I can't see how we could ignore that.

MR. CORRIGAN. Well, certainly I'm not saying--

MR. PARTEE. That's what we are supposed to be doing.

MR. CORRIGAN. That's precisely the point.

VICE CHAIRMAN SOLOMON. But it seems to me that that is the answer to your question, isn't it?

CHAIRMAN VOLCKER. Yes, but we open ourselves much more to this [criticism] if we don't have faith ourselves in these relationships over a period of time, or if we have less faith than we used to have.

Just to make this all worse in a way: I got the GNP flash. It may be crazy, but it's going to make all these velocity figures look worse. They have a nominal GNP increase in the fourth quarter--well, they raised the third quarter a bit but that doesn't make that much difference, I guess. They raised the third quarter by a percentage point, most of which is real. So there's a real increase in the third quarter with a -2.2 percent real GNP in the fourth quarter and only +2.2 percent nominal. So, we have to add another percentage point in the downward direction to all these velocity figures that we've been looking at if this figure is right on a quarterly basis.

VICE CHAIRMAN SOLOMON. They have come in with a plus for the revised third quarter?

CHAIRMAN VOLCKER. Yes.

MR. ALTMANN. It's plus .7 percent.

MR. FORD. The one before that was down to zero, so it's now back up to 1 percent?

CHAIRMAN VOLCKER. They raised the deflator a little. They have +.7 percent on real in the third quarter and +5.0 percent on the deflator; it was 4.8 percent. For the fourth quarter they have 4.6 percent on the deflator, which is 1-1/2 percentage point less than the staff forecast. We'll see which one turns out better in the ninth revision down the road! And they have -2.2 percent on the real GNP and nominal was only up then 2.2 percent. So, I guess this is roughly 1 percentage point less than we were assuming for the fourth quarter nominal GNP, which is going to lower all those velocity figures, if we believe the others. They have final sales up in the fourth quarter; [the downward revision] is all in inventories, which is not bad in terms of the outlook.

MR. BLACK. Do they have a percentage change there, Mr. Chairman, on final sales [in the fourth quarter]?

CHAIRMAN VOLCKER. Well, it's up only $500 million, so it's tiny. I was hoping to see what they have in inventories. I don't see inventories on this sheet. Do you have the sheet, Jim? It's not on page 1. Here it is. The change in business inventories in the fourth quarter was -$18 billion; that's obviously a big guess.

MR. PARTEE. There are a lot of guesses in there; final sales too. They don't have December retail sales figures; they don't have exports for two months at least.

MS. TEETERS. It's not a very reliable number; it just gives the general direction.

CHAIRMAN VOLCKER. No, it's not reliable. For what it's worth, that's what it is. Well, are there any other comments? I think we better get something out that will make all this a little more concrete.

MR. BOEHNE. I just have one more comment on our central tendency or whatever we're going to call it. Would it make sense to put it in terms of a range? We get a preliminary number [on GNP] and then a revision and then another revision and that's from the past let alone [forecasting] what the future will be. If we had a range of what our forecasts were, and we could conceivably make that range include whatever the Administration wanted, wouldn't that give us some flexibility and avoid the over-precision and still avoid a clash with the Administration? Do we have to have a number?

CHAIRMAN VOLCKER. I hope that whatever range we get encompasses what other people have. That remains to be seen. But this central tendency may not amount to much. It's possible that we will say here's the range of forecasts and it so happens that the individual forecasts are well dispersed within that range. I can't tell you anything more. But it might be that we would say this is the range but most of the people were in the lower half of the range or most of the people were in the upper half of the range. That's about all I intend to say--maybe a bit more than that, but as little more than that as we can get away with.

MR. BOEHNE. But the range also would help to avoid the Fed coming out with one thing and the Administration with another.

MR. PARTEE. Yes, and we've managed that in the past.

MS. TEETERS. Yes.

CHAIRMAN VOLCKER. I think it's going to be much harder this time, though. What bothers me about the Administration forecast is that they are likely to have a higher inflation forecast by a significant margin, not only for [the coming] year but a pretty high inflation forecast out into the future relative to what I think is going to happen. And that doesn't indicate great confidence in the success of the anti-inflationary program, for my money. They have a certain institutional bias; partly they have the budgetary problem. But in part it's because at least some of them want to make darn sure they're not very far away from the consensus of other forecasts. And if you look at the consensus of economic forecasts for the next few years, they have a considerably higher inflation rate than our staff seems to be [leaning] toward. So, if they go toward a consensus forecast partly for budgetary reasons but partly just because they want to be near the consensus, that puts us in the position of arguing that the inflation outlook is really better and it is doable. And they are saying, and everybody else is saying, we ought to be satisfied with a higher inflation forecast and have a more expansionary policy. That's my biggest concern. And it's not just next year's forecast. Maybe I'm wrong, but my gut feeling now is that this will be evident in the '83 forecast and in the 5-year forecast.

MR. WALLICH. Well, in comparing ours with those, I hope we can stretch the ranges as against the central tendency.

CHAIRMAN VOLCKER. It's a little premature because I don't know what [your forecasts will be]. There may be no central tendency, as I say. If the forecasts are well dispersed, all we're obligated to say is that the forecasts are well dispersed. And maybe that's the way it will be.

MR. BALLES. Mr. Chairman, you raised a question of whether we should all be using the same monetary assumptions. That's a pretty important guidepost for us to decide on one way or the other. It might be advisable, or at least helpful to me at the moment, if we could turn to the staff for a minute on this chicken and egg problem. You have a forecast, obviously, for 1983, as does my staff. And it's based on some provisional assumptions as to M1 growth, abstracting presumably from shifts in M1 because of these new deposit accounts. I think that is what the Greenbook said. Could you clarify, Jim, how you handled the monetary assumptions for the 1983 forecast you have?

MR. KICHLINE. We focused on M2 for 1983. Abstracting from the shifts, we used a number of about 8 percent. And compared to our nominal GNP, which I think is around 7-1/2 percent, that gives us very little change in velocity, which we thought was about right as a consistency check. We've gone around on that. The quarterly model, when you feed all the information into it, does dump out an M1 of around 6 percent, which we adjust to abstract from those shifts but allow for other demand shifts that come into the model; but it could be 2 percent or 10 percent; I don't know. But we are stuck in our forecast with an explicit assumption of 8 percent M2 growth Q4-to-Q4.

MR. PARTEE. Taking out the shifts?

MR. KICHLINE. Abstracting from the shifts.

MR. PARTEE. That amounts to some unknown amount over and above that.

MR. KICHLINE. That's correct.

MR. BOEHNE. And the interest rates are what you had in the back of the Bluebook? Is that what falls out?

MR. KICHLINE. Those are consistent with that assumption on the GNP forecast.

CHAIRMAN VOLCKER. Well, the reason I find your question somewhat unanswerable, John, is that one can always say it's consistent with this number or that number and think it is today. But if the Committee is in a mood of saying we may change that number if it turns out not to be consistent, where are we? Everybody is going to have his own opinion of it. If we were really saying we were going to aim at 8 percent M2 shift adjusted and we are going to stick with that target through hell or high water, then it's valid to say that's the assumption. If we are saying that's where we are going to steer it now but we are prepared to change it--

MR. BALLES. I was just a little concerned, Paul, that there might be a booby trap out there for you if you're questioned on this range of forecasts of the Committee.

CHAIRMAN VOLCKER. There's a whole mine field out there!

MR. BALLES. If it turns out that we're all using different assumptions on the growth of the Ms, it could be a little awkward.

CHAIRMAN VOLCKER. Well, if we go all the way in that direction, I literally don't know the answer. What we have then is a nominal or a real or an inflation target but everybody is saying that they are willing to change these things because that's in some sense where they want the economy to come out. How we can maneuver among this, I don't know.

MS. TEETERS. I'm curious as to how the staff anticipates drawing a reserve path.

MR. AXILROD. I assume the Committee will come up with, say, an M2 or an M3 guideline, or both, for the period over the next three months and we will simply make, as put in the Bluebook, an initial rough assumption of what would happen to M1 consistent with that; it's all rough. And that would imply a certain total amount of required reserves. The Committee, I assume, will come up with an initial borrowing assumption as it has been doing. We will provide an excess reserve assumption and with all those pieces we'd come out with nonborrowed reserves. It's fairly straightforward, except that we know we're going to be way, way off. So, when the deposit distribution changes, as it undoubtedly will, we would simply redo the reserve path in order to put in the more or fewer reserves that are consistent with the new deposit distribution, assuming the Ms are on track. If the Ms are off track, then we would have to change the reserve path for the change in the deposit distribution but in addition borrowing would tend to go up or down depending on whether the total was high or low.

CHAIRMAN VOLCKER. We can make up an arbitrary formula as to how to shift the reserve path in terms of deviations from these targets. I doubt that we would want to do that right now anyway. Inevitably we would end up, in some sense, with more important judgmental positions about when to change the path in the light of all these things going on. But I assume, as Steve says, that we will operate with a reserve path that has a certain degree of automaticity to it, but it probably will be pretty mild. Whether we want to make it more than that is going to have to be a judgment.

MR. AXILROD. The multiplier adjustments are fairly straightforward. That is, if there is a vast increase in Super NOW accounts and a drop in savings deposits that we hadn't allowed for--savings deposits having no reserve requirement virtually and Super NOWs having a 12 percent requirement--then we'll observe that this week. The reserves come in two weeks from now and we will have put into the reserve paths sufficient reserves to accommodate the big increase in Super NOW accounts consistent with a drop in savings accounts.

CHAIRMAN VOLCKER. When do we actually get numbers on these new accounts?

MR. AXILROD. Well, pretty soon. That's one thing I wanted to mention. We are going to be getting the numbers weekly on the new accounts. We have before the Board a proposal to get from the weekly reporting banks [data on] accounts over $100,000 that are nonpersonal accounts with seven days or more maturity. That's in case some of the large CDs that are now in M3 shift right into money market accounts. [Mr. Lindsey,] what are you getting explicitly? Are you going to get a breakdown between personal and nonpersonal on these new accounts?

MR. LINDSEY. No, we're getting separately on the report of deposits a slip sheet, starting with the first week of introduction and for receipt at the Board with about a 10-day lag or so, the macro amounts in the new MMDA in total. And then, as Mr. Axilrod is saying, in addition we are asking for some other weekly information on the report of the large banks on the MMDAs with amounts over $100,000 and maturities of seven days or more. Similarly, when the Super NOW comes in, we are going to get information on that account for--in our proposal--a temporary period of a month on the report of deposits, which is a universe report, and then subsequently somewhat less frequently on other reports.

MR. PARTEE. But we are also getting the distinction between personal and nonpersonal. We must be because of the different reserve requirement.

CHAIRMAN VOLCKER. Yes, I don't know why [unintelligible] you want anyway.

MR. PARTEE. I'm sure.

MR. GRAMLEY. On the report of demand and time deposits? You have to because--

CHAIRMAN VOLCKER. Well, we'll have to sort that out. We better not sort it out here. Is there anything else to be said on this broad subject? Does anybody have a feeling that we ought to have a meeting in the middle of January sometime?

VICE CHAIRMAN SOLOMON. How much time is there between our February meeting and [when] you testify? A week?

CHAIRMAN VOLCKER. I'm trying to make that as short as possible, but with all these complications--

MS. TEETERS. The meeting is set for February 8th and 9th and the budget comes in on January 31st with the economic report, or probably two days later. So, we're going to be fairly constrained at both ends.

MR. PARTEE. When is our meeting?

MS. TEETERS. February 8th and 9th.

VICE CHAIRMAN SOLOMON. And Paul wouldn't testify until when?

MS. TEETERS. Until the 20th.

CHAIRMAN VOLCKER. I would like to testify as soon as possible after the meeting. But it sounds to me as if it's going to be a whale of a lot more complicated to write this than it was before. Maybe we can do what we did before. We can have that meeting on the 8th and 9th and have another meeting, at least on the telephone, on the 15th or so. [That may be] what we end up doing.

MR. BALLES. I liked your idea about asking Steve to try to formulate the framework within which this whole thing could be presented. I'd simply like to suggest that we wait to get that before deciding whether we need a meeting in January. Maybe he's so good at it we won't need the meeting or we could settle for a telephone call.

CHAIRMAN VOLCKER. The more I think of it now, instead of a January meeting, maybe we ought to get that format as soon as possible. Maybe the relevant question is not having a meeting before the 8th and 9th but whether we need a meeting after the 8th and 9th.

SPEAKER(?). Yes.

MR. BLACK. I think that's better, Mr. Chairman.

CHAIRMAN VOLCKER. All right. For a little change of pace, why don't we go to the international report and then come back to [the domestic side].

MR. CROSS. [Statement--see Appendix.]

CHAIRMAN VOLCKER. I want to get into this matter of the swaps a little, but are there any questions or suggestions on the non-swap issues or market developments?

MR. BOEHNE. Just a question: The Greenbook forecasts of the current account and trade deficits are much larger than I at least have seen from other people. Is it that we know something they don't know? Why do we have a so much more gloomy forecast for the current account deficit?

MR. TRUMAN. I don't really have a good answer to your question. The one area where we may know a bit more than is incorporated in other forecasts is on the agricultural side. That's an area over recent months where we have lopped $2 or $3 billion off the current trade and, therefore, the current account forecast. Another factor is that we have been making an explicit provision for the weakness in the developing countries, which is hard to do, and therefore we have a somewhat weaker export picture than many of the private forecasters have. A third area, which is related to that, is on the services side, where we also think that there will be an impact explicitly from Mexico of $1 billion or more. That will reduce service [unintelligible] from Mexico, which is nontrivial, since their investments are so large there. Putting those all together gives us a round number of about $50 billion in contrast to the private forecasts which are now on the order of $20-some billion or something like that. I might add that that $25 billion or so is well within the standard error of forecasting when we're dealing with numbers that are as large as they are these days.

MR. PARTEE. The standard error is $25 billion?

MR. TRUMAN. Well, it's hard to calculate what a standard error is in these cases, but we're talking about the difference between two numbers with a gross total of over $1 [trillion].

CHAIRMAN VOLCKER. The biggest element in all these accounts is this statistical discrepancy. I find our forecast a bit unbelievable in the sense that if the deficits are that big something is going to happen and all hell is going to break loose. It's a difficult area. Anything else? It's a major depressing factor on the economy. I don't think there's any question about that. It appears in so many industries and it's not all analyzed in the same way, but there's no question that exports are going to hell.

MS. TEETERS. How much more depreciation in the dollar are you expecting, Ted?

CHAIRMAN VOLCKER. Plus or minus 25 percent!

MR. TRUMAN. Minus 20. In terms of our weighted average, it was around 1.20 yesterday. I think the direction is more important in terms of the forecast than the extent. We have assumed it will go down to about 1.03, so that's about 15 percent.

MS. TEETERS. And that will take the relationship to the mark to approximately what?

MR. TRUMAN. Well, the mark will go down probably somewhat more than that--by about 20 percent. If the average goes down 15 percent, the mark presumably would have to go down more than that.

MR. FORD. So that puts it up close to 50 cents for the mark?

SPEAKER(?). Yes.

CHAIRMAN VOLCKER. More than that if the mark were down--how much did you say?

MR. TRUMAN. I said 15 percent for the average.

CHAIRMAN VOLCKER. If it's 20 percent for the mark, you get 48 off the mark and the mark is down to 1.90.

VICE CHAIRMAN SOLOMON. Most of the market participants would have it somewhat higher than that. At least the ones I've talked to would have it more in the 2.20 range.

MR. TRUMAN. Well, that would be a 10 percent or 15 percent adjustment. Then we are not going to get as much [of a weighted decline in] the dollar; if you want to [extend the forecast] into 1984, you're not going to have as much of a current account adjustment.

CHAIRMAN VOLCKER. What are you assuming the impact of your exchange rate forecast has on inflation?

MR. TRUMAN. In the longer run, there's always a question on those kinds of calculations as to whether to treat the exchange rate as an exogenous variable, which I think one can't. But treating it as an exogenous variable, a 10 percent decline gives you something on the order, eventually, of a 1-1/2 percent increase in the price level in two years or so.

MR. PARTEE. It will be more an '84 effect than an '83 effect.

MR. TRUMAN. Right. So, as I said the other day, it's not a net [adjustment], because in some sense we haven't yet had a lot of the impact from the appreciation of the dollar that we have experienced for most of 1982.

CHAIRMAN VOLCKER. On the swaps with Mexico, we have some share of the $925 million. What is that share? I forget.

MESSRS. TRUMAN and CROSS. $325 million.

CHAIRMAN VOLCKER. It's $325 million, which is not all paid out yet, but will be paid out presumably by the end of this month.

MR. CROSS. Very likely.

CHAIRMAN VOLCKER. And the part of it that goes back earlier is going to have to be rolled over. I don't think there's any question about that. The earliest that is going to come out or begin to come out is May, with the second phase-in of the bank and the IMF [loans]. Let me go backwards. On the Mexican deal, as you know, the point of getting a tranche [from] the banks is far from complete. I don't know how much they will come up with of the $5 billion total. But we should know this week. And we just have to presume that it's going to come close enough to make the whole thing proceed. If it does, one option--the leading option--is that we will get paid back that original $700 million. We may get paid back some of it before the end of the year out of part of an IMF drawing. And the rest of it will get paid back very early next year out of the combination of IMF and bank money. The position that I've taken is that that should be paid back to us as soon as there is enough liquidity and that should be there for an instant anyway. There is a major question as to how Mexico will get through to the next bank drawing and the next IMF drawing in May. And it seems to me that what we have to be prepared to do is to get paid--and I think it would be preferable, although some of our foreign partners don't like it--on schedule so to speak, out of these first IMF drawings and, in fact, mostly out of the bank drawing so that we are down to zero on that old swap. I can't guarantee that this is possible. But we'd put that back on a standby basis where it is available to Mexico to meet a squeeze they may have before the bank payment. Presume we get paid off again, then. If they do draw in whole or in part, we'd have it ready to come back before the next one following that; that is, we'd keep it on a standby but usable basis. And the net effect of that--if the whole Mexican program goes according to Hoyle--would be that all this central bank money can get paid out by the end of the year. The whole financing plan is based upon that presumption. Obviously, things can go wrong. A major hazard in the case of Mexico, because we know they have had bad crops, is that they are going to have to import more agricultural products than was really allowed for in this program. Some of that and maybe all of it can be covered by the CCC, but we [don't] know that that will be the case. If there is a significant decline in the price of oil, Mexico has a problem and they will not be financed. It's a contingency we'll have to meet if it happens. [The financing] has some nice effects, but this is one of the bad effects. Leaving those kinds of contingencies aside, we should all be paid by the end of the year. We may be out of the $700 million for a period of weeks or months, if all goes according to Hoyle. But I do think we ought to be ready to put it back in again. I just want to make sure there's an understanding of that; I don't know that it has to be a formal Committee action.

MR. ALTMANN. If there are no objections, that's all we need.

CHAIRMAN VOLCKER. But when they draw again that doesn't have to be any formal Committee action?

MR. ALTMANN. Oh, for that size, yes.

CHAIRMAN VOLCKER. What is the size that doesn't [require a formal Committee action]?

MR. TRUMAN. Anything over $200 million does.

CHAIRMAN VOLCKER. So we could put some back in without a formal Committee action. But I think there ought to be an understanding of that approach, a kind of consensus that it is desirable or feasible. So, I'll ask you that question at this stage.

MR. PARTEE. I certainly think they will need to have some flexibility and this is supposed to provide it. I think it's the right thing to do, so I would be favorably inclined.

VICE CHAIRMAN SOLOMON. What do we do if the Mexicans come in and say: We are so short of reserves or liquidity that we ask you to defer--not to take repayment and just roll over the loan for another three months or six months?

CHAIRMAN VOLCKER. Well, you have to make two assumptions. On the assumption that the program goes through, I don't think that can happen early in January because they're going to have so much paid out to them at that point that they are going to have enough money for at least a little while. They are going to have $2 billion paid out to them all in one lump sum. It may not last all that long but for a while they're going to have the liquidity. That question arises late this month before they get the big payment, and I think we just have to be a little flexible about this. It's a question of whether we get a couple hundred million paid before the end of the month or whether we wait until January 7th or something like that. But that's on the assumption that the program goes through. If there's not enough bank money in there, or if there's no bank money, there probably won't be any IMF money either. If the program doesn't go through, we can't get repaid.

VICE CHAIRMAN SOLOMON. Let's say we're halfway between the scenarios: The bank money is coming in slowly, though not for the full amount, and the IMF money is going ahead. Do you still think there will be enough to pay us out and then we would put it back on standby?

CHAIRMAN VOLCKER. I can think of all sorts of in betweens where we would get some of it paid out but not all of it. It can go any place from being paid back $1 to being paid back $700 million.

VICE CHAIRMAN SOLOMON. The substantive difference is simply that we keep them on a tighter leash if we insist on getting paid out and then put it back on a standby basis and release it only in bits and pieces as we feel is justified. I think that's the right approach.

MR. PARTEE. It just seems too uncertain, though, doesn't it, Tony? We just don't know. That bank credit might be [$4] billion instead of $5 billion or something like that. I don't know what a little shortfall like that does to their arithmetic.

CHAIRMAN VOLCKER. It will be more than $4 billion but the question is at what stage is it so small that the IMF doesn't feel able to go ahead?

MR. PARTEE. That will really be serious.

CHAIRMAN VOLCKER. Then we have a real problem. But they already have [commitments for] basically more than $4 billion except that some of that is contingent on getting more, so it's not perfectly clear yet.

VICE CHAIRMAN SOLOMON. Some of it is contingent also on not triggering the 1 percent SEC disclosure requirement; some of it is contingent on not exceeding the legal limit; most of it is contingent, in theory at least, on everybody else putting up their share. Certainly the IMF would accept $4-1/2 billion; whether they will accept significantly below $4-1/2 billion is the question.

CHAIRMAN VOLCKER. I don't think the IMF has said they would accept $4-1/2 billion except as a starting point--that they might go ahead temporarily if Mexico will be getting the rest later. Well, we just have to wait and see. But that's the general strategy. On Brazil, which is not irrelevant even though we have no money in there, the Treasury lent them $1-1/4 billion a couple of weeks [ago], which is the total amount of the Fund compensatory finance and first tranche--

MR. CROSS. Gold tranche.

MR. TRUMAN. Gold tranche, reserve tranche.

CHAIRMAN VOLCKER. It is the gold or reserve tranche and in that sense is secured. The Treasury then went ahead and lent them another $250 million to bridge them over until they could meet with the banks last week and get some more bridging money from the banks. That amount will be counted against a BIS facility, which is under discussion. The Treasury would participate in that to a total amount of $500 million, of which they've already put up this $250 million. Other countries would [put in] $700 million. That seems to be on track with the BIS and probably will be finalized this week, with the possibility of another $200 to $300 million from That is designed to keep Brazil afloat until they negotiate new money with the banks, they hope by early January. That process just began yesterday. There will be, to choose the words carefully, a voluntary rollover of existing maturities for Brazil next year--which amounts in practical effect to a standstill, in the Mexican pattern--and $4-1/2 billion, roughly, of new bank money plus $1-1/2 billion that they think is already committed for next year. So it's really a total of $5.7 billion, roughly, of new bank money next year, all under negotiation at the moment along with some other things like keeping their branches and agencies afloat. Hopefully, that will proceed with the BIS paying out all this money and with the Treasury in for up to $500 million during the next couple of weeks--the Federal Reserve is not involved at all--bringing the total Treasury exposure up to roughly $1-3/4 billion in Brazil. Again, all the financing plans are predicated on the proposition that all that money will be repaid over the course of the next year. In fact, the existing $1-1/4 billion of the first section of Treasury money is to be [repaid] quite promptly out of the Fund drawings in a matter of weeks, if all goes well and according to plan. Again, that is predicated on everything going according to Hoyle and the banks coming up with $4-1/4 billion or $4-1/2 billion, which I presume is going to take a certain amount of front loading too. None of that is decided, but that's the plan that is being presented. So, the Treasury would be paid most of its money fairly quickly if everything goes well. The remaining $500 million would be paid out over the course of the year and probably late in the year. But there is a considerable Treasury exposure there.

Moving farther south, we have Argentina. Less money is involved, but there is a plan for the banks to put in some bridging money and then put in some medium-term money later in the year, increasing their exposure on the order of $1.1 billion or something like that.

MR. TRUMAN. That's the bridging. At the end of the year that exposure would be $1.9 billion.

CHAIRMAN VOLCKER. A $1.9 billion total increase in exposure?

MR. TRUMAN. Without taking account of the fact that some of the money will be repaying some of their arrears.

CHAIRMAN VOLCKER. That is pretty well negotiated by the banks. A lot of that money does go, as Ted said, toward paying arrears. It is not enough money to get Argentina, in terms of timing, anywhere near up to date early in the year. So, the theory is the BIS will provide, with United States and other support, say, $500 million in the next few weeks to Argentina. That money together with bank money would eliminate most if not all of their arrears. That would get them back on a current basis. Again, if the financing program works out the way it's supposed to work out, and this is more agreed than the Brazilian program--there are many fewer banks involved, only a few hundred instead of over a thousand and the amounts are smaller, so it's much more manageable--the central bank money would come out basically in May and August.

MR. CROSS. Well, before six months.

MR. TRUMAN. Well, maybe, six months.

CHAIRMAN VOLCKER. Okay, a little before that.

MR. CROSS. By the end of June.

CHAIRMAN VOLCKER. By June?

MR. CROSS. That's the scheme.

CHAIRMAN VOLCKER. If everything goes according to Hoyle. The plan discussed for Argentina is that the BIS would advance all the money under an arrangement in which they already have a of some considerable size--they've had it for some time--from Argentina. Argentina has The BIS would advance all the money knowing that if it is not repaid, they can exercise their right of offset against the That is not entirely free of legal doubt because there are negative pledges which our legal counsel tells us do not apply to a right of offset from an existing but that could be contested. It would be paid formally out of Fund drawings. There is not only bank money in Argentina but there's a Fund drawing and the Fund drawing [amounts to] $1.3 billion or something like that over the course of the year. So that would be some multiple of this BIS assistance. But, obviously, there are two contingencies. One is that the right of the BIS could be contested legally if it came to that. And the general contingency is that if something goes wrong with the program, even if they get the Fund money--and they may not get the Fund money--there may not be enough money there to pay off the BIS. And the BIS doesn't particularly want to end up with It's just too big an amount. So there are several risks that the BIS has to be protected against. And the arrangement is that central banks or governments would protect the BIS against those risks by--I get a little out of my depth here on the technicalities--temporarily providing a deposit to the BIS if they don't get repaid. But ultimately, if they So the central banks would agree

MR. FORD. When is then?

CHAIRMAN VOLCKER. Whenever it was done. It means that if they haven't been repaid, they eventually would we're probably talking two years from now.

MR. FORD. The question is: Do the central banks take them out of the risk

CHAIRMAN VOLCKER. After they have The BIS would

So that's one contingency they want to be protected against, and I think it's appropriate. Another one is that if in fact there is a successful legal challenge to

which would repay them. I suppose it's a similar risk. If eventually Argentina doesn't pay them, they want the central banks just to take over the loan, in effect. So an agreement has been drawn up to cover all those contingencies in which the United States will participate; in fact we originated this. There is still a question as to what the U.S. share will be. If it's 50 percent, which is the preliminary thinking, it would be $250 million, obviously. It may end up being more than that. And then there is the further question of whether the Federal Reserve or the Treasury does it. That has to be looked at in the light of the Treasury's exposure to Brazil. I have had some discussion with the Treasury that we would either do this or maybe instead take over part of their Mexican exposure and let them do Argentina in whatever the amount is. But I have to get your opinion on these matters.

MR. FORD.

CHAIRMAN VOLCKER. But if we take the Argentina loan, we would agree eventually to these contingencies.

MR. FORD.

CHAIRMAN VOLCKER. None of this requires any formal action--although I will take advice on this--because we are not lending; the BIS is lending the money initially. It's going to be lending the money against these guarantees from the United States, whichever agency does it, and from other central banks. We do have to enter into the agreement with the BIS, but it's not a swap or a loan now. But it is an agreement under certain contingencies to make a loan one year or two years down the road. And you have to understand that and agree to it. As I say, it doesn't necessarily have to be us and Argentina. Argentina is an Article VIII country, which is one place where we draw the ring around swap agreements. Brazil is not. But we've never had a swap agreement with Argentina; we wouldn't have to have one now but we would be committing ourselves under certain eventualities to have one at some point. Or the Treasury might agree to our just confining our activities to Mexico, where we have a precedent, and they would do Argentina; I don't know. Plus, I'm not sure it makes a lot of difference. The only difference I can really see is that if we do it with Argentina--and I think there are some pluses--the minus is that we have extended the possibility of a swap agreement to a country where we never made one.

VICE CHAIRMAN SOLOMON. Well, isn't there a complication in the very unlikely event that we end up

CHAIRMAN VOLCKER.

VICE CHAIRMAN SOLOMON. Okay, but

MR. TRUMAN. Sure,

CHAIRMAN VOLCKER. If we do it, we will immediately make an arrangement with the Treasury, I presume, that

MR. TRUMAN. The issue is

MR. BRADFIELD. Yes,

VICE CHAIRMAN SOLOMON. Exactly.

MR. BRADFIELD. They

MR. BALLES. That sounds like a real good deal!

MR. BRADFIELD. They haven't worked that out exactly.

MR. PARTEE. Well,

MR. BRADFIELD. Yes.

CHAIRMAN VOLCKER. They would have to

MR. CROSS.

MR. BLACK. We'd better check with Mr. Edwards before--

CHAIRMAN VOLCKER. But the Treasury

MR. TRUMAN.

VICE CHAIRMAN SOLOMON. I don't think so.

MR. TRUMAN.

CHAIRMAN VOLCKER. That Treasury is as broad as all outdoors.

MR. CROSS.

VICE CHAIRMAN SOLOMON.

MR. CROSS. I think so.

MR. BRADFIELD. The Exchange Stabilization Fund could
They could

VICE CHAIRMAN SOLOMON. So, from that point of view it would be better for them to do the Argentina deal.

CHAIRMAN VOLCKER. These are details.

MR. FORD. Why are we doing all this? We are not a full-fledged member of the BIS, as I understand it, for historical reasons. I take it the reasons we're taking BIS out of what appears to them to be a substantial risk is because they are performing the service of getting these other central banks in on the deal and that's the most efficient way to do it. Is that it?

CHAIRMAN VOLCKER. Well, basically yes. We could do it all ourselves directly but there are legal problems with our doing it directly and They happen to have

But the other substantive point is that it makes it multilateral instead of bilateral, and it's a convenient way from that standpoint.

VICE CHAIRMAN SOLOMON. I thought the

Are you saying it's already legally--

MR. CROSS. It's already

CHAIRMAN VOLCKER. It's

MR. CROSS. We

MR. BRADFIELD. It is the

MR. FORD. Get your Ayatollahs straight!

MR. GUFFEY. The maximum exposure would be $250 million, roughly?

CHAIRMAN VOLCKER. Well, I can't say that for sure. If it's a 50/50 split, it will be $250 million. But, frankly, the United States was the progenitor of this and we told them we, the United States, would do more than 50 percent if that was necessary.

MR. FORD. Why 50/50? Even in the United Nations, we don't take 50/50 any more.

CHAIRMAN VOLCKER. Well, we've had endless discussions about this. That's the price of world leadership, I guess. The Treasury got its back up on this Brazilian deal, quite rightly, and that's why that one is 500/700. And, of course, it's 500/700 in that portion of the agreement. They already had $1-1/4 billion [in loans to Brazil]. And the BIS wanted them to put in 50/50, particularly considering all this other stuff. And that was finally accepted with some effort.

MR. WALLICH. Well, this is partly a reflection of the fact that we don't participate in situations like Hungary and very marginally only in situations like Yugoslavia. So, they feel they have their clients and we have our clients; that is working out to our disadvantage right now, but it was to our advantage earlier.

CHAIRMAN VOLCKER. You stated that a little too generally, I think, Henry. The historical fact was--but it wasn't a policy and your comment may have been interpreted as general policy--that we did not participate in Hungary for purely political reasons. The Administration was anti-eastern Europe. That grates on their mind, and it hasn't helped in this case, but it was just the particular case of Hungary where it turned out that we did nothing and the BIS was very proud of themselves for taking the whole thing. But it certainly is in their mind as are some of these other things: Latin American is your area; Hungary and Yugoslavia we would [unintelligible]--

MS. TEETERS. What are the resources of the ESF?

CHAIRMAN VOLCKER. Mr. Cross, what are the resources of the ESF?

MR. CROSS. I think their balance sheet is about $6 billion but a lot of it is tied up at this point.

VICE CHAIRMAN SOLOMON. It's higher now.

CHAIRMAN VOLCKER. It's always a matter of interpretation with the--

MR. TRUMAN. They have, for example, $2 billion that they owe to the general fund.

CHAIRMAN VOLCKER. It's a question in the end of how much risk they can take care of. They can always borrow or expand their resources, but there's a limit to the risks they want to take.

VICE CHAIRMAN SOLOMON. Will they have to warehouse with us in order to do some of this? Are they sufficiently liquid to do all these transactions?

CHAIRMAN VOLCKER. Well, of course, Argentina isn't going to cost anybody any money in the United States initially. The BIS is going to finance it all. I don't know what the--

MR. TRUMAN. Nor will Brazil.

MR. CROSS. Also with the Brazilian deal the BIS provides the cash and there's nothing to be--

CHAIRMAN VOLCKER. That's right. In Brazil they are going to do it that way, too. So, the Treasury is just going to backstop the BIS for the--

VICE CHAIRMAN SOLOMON. Okay, but the Treasury also is considering a $300 million swap with Mexico and a $500 million oil advance.

MR. TRUMAN. Not the Treasury.

VICE CHAIRMAN SOLOMON. That would affect the liquidity of the ESF.

CHAIRMAN VOLCKER. Well, I'm not sure about the oil advance; it comes out of appropriations, I guess. But it is true, and I forgot to mention it, that the Treasury is willing to advance a further $300 million to Mexico in the next few weeks to ease their bind. That's also going to get paid out next year.

MR. FORD. Ahead of us, behind us, or at the same time?

CHAIRMAN VOLCKER. Behind us--behind our first [advance], not the BIS part. Where do we stand? On this $700 million, to the extent we put it back in, we will be behind everybody else. Again, the whole program assumes that this will all come out during the course of the year. But when that $700 million goes in we can't be ahead of the BIS including the part we have in the BIS. We don't leap frog over that.

MR. FORD. In other words, we're not just making a decision to re-establish our $700 million swap; we're re-establishing it in a less creditworthy position in the line-up. That's what it boils down to.

CHAIRMAN VOLCKER. A more delayed position in the line-up anyway.

MR. PARTEE. Well, we're the banker.

CHAIRMAN VOLCKER. That is correct.

MR. FORD. I'm still thinking like a commercial banker.

CHAIRMAN VOLCKER. No, that's right. It hasn't been arranged yet, but I think that's the realistic presumption: That it will come out after the BIS. There should be enough money. Again, you've just got to assume--presuming that the program works--that there will be enough money to pay off the BIS in May and in August, including our portion of the BIS loan in May and August. Some of that, of course, is not out yet. Some of it went out in September; that part will be paid off in May. The part that's going in now will get paid off in September, if everything goes on schedule. If the whole thing falls apart, it falls apart. That's been true all along, I'm afraid. Oh, we are secured by this oil [collateral], but the BIS part is not--not the swap.

MR. GUFFEY. At current prices?

CHAIRMAN VOLCKER. No, it's the amount of oil sufficient to pay off the debt.

MR. BRADFIELD. It's not the assignments of payments that are coming due, so it's not related to the present crisis.

CHAIRMAN VOLCKER. It's secured by enough oil to pay it off.

MR. CROSS. Right.

MR. GUFFEY. Whatever the volume of it.

CHAIRMAN VOLCKER. Or whatever that's worth.

MR. BRADFIELD. And it's oversecured; it's about $2-1/2 billion for a $1.8 billion credit.

MR. BALLES. What is the legal basis, Mr. Chairman, of our moving in at the last minute, so to speak, on these loans to the three countries you've mentioned and standing in a superior position to private banks? I have a recollection that that has been challenged legally. But I'd like to get brought up to date on that.

MR. BRADFIELD. This is a question of our having a superior position to the banks?

MR. BALLES. Yes. I thought some private banks were challenging us.

MR. BRADFIELD. The only case that I know of at this point was the challenge raised by Citibank to the Export Import Bank's preferential position in connection with the loan to Zaire. And that never went to a judgment.

CHAIRMAN VOLCKER. I think what John may be referring to is whether we are violating the negative pledge clauses that are here, which is--

MR. BALLES. Yes.

MR. BRADFIELD. That's the same issue that was raised in that case and there has never been a clear adjudication of that. We have designed the arrangements to be consistent with the negative pledge clause.

CHAIRMAN VOLCKER. We think. But they are not free from challenge.

MR. BRADFIELD. Well, no. We've designed them so that they are--

CHAIRMAN VOLCKER. To the best of our ability they have been so designed.

MR. BRADFIELD. They've all been very broadly drawn. Some of them say "any arrangements designed to provide preference," and that is so broadly phrased it is very hard to find complete avoidance techniques with respect to negative pledge clauses. But the Mexican arrangement is designed to provide a deposit with the BIS and the right of set-off. And the right of set-off has consistently been held not to violate negative pledge clauses. Every agreement that we've seen that has a negative pledge clause also has a set-off provision. And this set-off provision, for example, under New York law, is very broad, which is what we intended to use So, essentially we're taking advantage of a method that allows for deposits to build up, which is with the right of set-off in case the debtor doesn't pay his obligations. And the right of set-off has been known to be consistent with negative pledge clauses.

CHAIRMAN VOLCKER. This is why we don't want in the case of Argentina. It raises less question about whether this is setting up a preference arrangement.

MR. BRADFIELD. The agreements by the various countries had their IMF deposits and were not creating any security interest in those IMF obligations or IMF drawings. So there's no inconsistency there with existing agreements either. The promise of Mexico to pay us out of the first IMF drawings is similarly not a violation of negative pledge clauses.

CHAIRMAN VOLCKER. That is one difference, let me say, in our taking over more of the Mexican one [versus] doing the Argentine one. None of these is black and white in the sense that if we basically do Argentina, I think the Treasury would go in there for a [small amount] just to show that we're in there together. But if we do Mexico, it will mean an immediate swap agreement because that's the way the Treasury is financing this Mexican agreement. If we do Argentina, [the loan] may never [be made]. All we would be doing is making a promise to [lend] later under a carefully defined set of conditions that we do not think will materialize. They will only materialize if one of these contingencies is triggered--basically that Argentina can't repay the loan on schedule and

MR. PARTEE. It sounds to me as if there's distinctly less exposure there than there would be on another $300 million to Mexico.

CHAIRMAN VOLCKER. Well, in any event, if we do the Argentine thing, I would want the Treasury to do at least a little of it just to indicate that it's a joint effort. But is that the preferable course in terms of the [Committee's view]?

VICE CHAIRMAN SOLOMON. If the technical consideration of

is not significant--if it's purely doable but a greater technical complication for us to do the Argentine thing--then from a more substantive point of view, rather than increase the Mexican exposure, we might very well take a substantial share of the Argentine commitment.

CHAIRMAN VOLCKER. The only negative in the Argentine commitment, just to repeat, is that it's a new country [for us].

VICE CHAIRMAN SOLOMON. Right. But it's an Article VIII country.

MR. WALLICH. It would open up a new swap relationship?

CHAIRMAN VOLCKER. Possibly. I just want to get the assurance from the lawyers if we do it this way that we have to make an agreement with the BIS.

MR. BRADFIELD. With the BIS, that's right.

CHAIRMAN VOLCKER. And that doesn't take a Committee vote?

MR. BRADFIELD. No. This would be the placing of a deposit, and it is within the jurisdiction of the Board to approve the actions by the Federal Reserve Bank of New York and [unintelligible] with that similar situation with respect to The New York Bank can enter into an obligation from the BIS. That would also be an action that the Federal Reserve--

CHAIRMAN VOLCKER. So, it would take a formal action by the Board?

MR. BRADFIELD. Yes.

MR. TRUMAN. An eventual action, Mike.

CHAIRMAN VOLCKER. But presumably we--we, the Board of Governors--would take an action now against the contingencies?

MR. BRADFIELD. That is correct. The Board would have to make the agreement now with the BIS to undertake the two obligations to place the deposits with the BIS in the event that it had liquidity problems arising from the fact that Argentina couldn't pay

CHAIRMAN VOLCKER. You're saying we will take a formal action but because of the particular form it will be a formal action by the Board of Governors and not the Open Market Committee?

MR. BRADFIELD. That's correct.

MR. TRUMAN. What about that proposal on the eventual workout? If there were an eventual workout way down the road, if the BIS wasn't paid, then that could also be done on the basis of

MR. BRADFIELD. That would [involve] working out the repayment of the deposits. If the BIS, after a period of, say, two years, were unable to be repaid by the Argentines, then we would in effect take over the claims against Argentina in repayment of the deposits. That would be the backup.

CHAIRMAN VOLCKER. I basically left out this interim step in my original description. We would only, in effect, get to a swap agreement way down the road after this deposit had been there too long.

MR. TRUMAN. But we need not even have a swap agreement in that case. I think that's what Mike was saying.

MR. BRADFIELD. What we would be doing is buying a participation in the BIS's claim against Argentina. The reason we're doing that is to maintain the BIS's right to set-off against whatever assets they might have with Argentina

CHAIRMAN VOLCKER. I think I have the sense of the [meeting] at this point. From a general policy standpoint, we prefer to do it with Argentina, probably with at least a little participation from the Treasury directly to show the flag. And whatever formal actions have to be taken will be taken by the Board. Let's have a little break. Oh, we have to ratify the transactions.

MS. TEETERS. So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. And the possible renewal of the swaps.

MR. MARTIN. Moved.

CHAIRMAN VOLCKER. So ratified.

[Coffee break]

CHAIRMAN VOLCKER. [Unintelligible] about Argentina, about Brazil.

MR. PARTEE. Is that the end of your list? You don't have any others on your list?

CHAIRMAN VOLCKER. Other countries? Yugoslavia is the other possibility, but that's mainly a governmental medium-term credit. Just to repeat a point, if we get Mexico, Brazil, and Argentina settled, and perhaps Yugoslavia would be useful in another part of the world, I think the rest of these can go and hang there, to put it bluntly. I don't think it presents a threat to the world banking system if we have these big countries stabilized, and that has been the [focus of the] whole effort. We haven't gotten them there yet, but that's the strategy. If we can get the Mexican and Brazilian situations stabilized, and Argentina is also big, I think we will have the whole situation stabilized because there's nothing else big enough and they'll never sell it to--

MR. BOEHNE. In other words if there is a default in one of the smaller countries, the banks could eat it.

CHAIRMAN VOLCKER. Right.

MR. BOEHNE. Maybe they even should eat a little.

CHAIRMAN VOLCKER. Exactly. They should have eaten some of this. Well, they will in some of the private credits. There are a number [of risks]--even if everything in our financial manipulation goes well. For Mexico there is the obvious threat of an oil price decrease, which would be very destabilizing to Mexico. It would help

Brazil some; Argentina happens to be fairly neutral there. The other thing is if we don't get some economic recovery here, none of these countries is going to have a good enough current account position to make the arithmetic come out. Nobody is projecting a great ebullience in the economies of the industrialized world. But if we had [no recovery] at all, it probably would be impossible for these counties to meet the current account objectives that are in all of these IMF programs. And, of course, they all have the risk that even in a reasonably favorable world environment they may be unsuccessful in carrying out their programs. So, we're not exactly home free. But in the next couple of weeks we might be in a position where for the moment we have it somewhat buttoned up.

MS. TEETERS. Isn't there also a problem of potential civil disorder in Mexico if they become too austere?

CHAIRMAN VOLCKER. Well, that's part of not being able to carry out the program. That is present in all these countries.

MS. TEETERS. Less so in Argentina?

CHAIRMAN VOLCKER. Well, in Argentina the dimensions are different. I think the general consensus is that they have a much easier economic problem, but they have such a weak political situation that they may not be capable of carrying through even a more modest program because their political situation is so weak.

VICE CHAIRMAN SOLOMON. Bill, you were making some remarks yesterday afternoon that this assistance to Mexico and Brazil, etc. is all part of an inflationary danger. I don't see that. It seems to me that the bottom line in those countries is that they are going to have to have much tighter fiscal and monetary policies as a result of the IMF adjustment programs. And there's the fact that they are going to get a much smaller amount of new money than they got last year and the year before, and so forth. I don't quite see why you conclude that we are adding to inflationary pressures with this assistance.

MR. FORD. First of all, the question is: What is happening to global monetary liquidity as a result of all of these things? You can take it either as a statement or a question. The statement is that there's a danger that global monetary liquidity can be excessively expanded through all of these credit [extensions].

VICE CHAIRMAN SOLOMON. I don't think that is what is happening. We are getting some contraction in the interbank credit market globally.

CHAIRMAN VOLCKER. World reserves are going down quite precipitously now. These actions tend to keep them higher than they otherwise would be, but they are going down rather rapidly. The next danger items may be some countries in the industrialized area of the world. France has lost on a net basis what--$19 billion or $17 billion of reserves in the past 18 months?

MR. TRUMAN. $17 billion is what we came up with.

MR. CROSS. I have a $19 billion estimate.

MR. FORD. The other aspect of this that bothers me is the fact that the Presidents of the [Reserve] Banks that I have talked to are all very uneasy about having someone in their Bank make phone calls in which we are in effect saying to the banks: If you will put forward your share of the new package of $4 to $5 billion, we would wink at the realities of the creditworthiness of your loan. That makes me very concerned.

MR. WALLICH. That wasn't the language that was used.

MR. FORD. What I'm saying is that that is certainly the way it's being interpreted in the marketplace.

VICE CHAIRMAN SOLOMON. There are a couple of newspaper reporters who have taken that line. Sydney Marks--do you know him?--did in a column recently. He is not in one of the major newspapers. But I have not heard the view expressed in the markets in any widespread way at all that we are encouraging irresponsible behavior by our approach to this regulatory problem.

CHAIRMAN VOLCKER. There was an article in The New York Times that suggested something in that direction. But we have not been nearly as forthcoming as the banks would like us to be. I understand we have not given them any assurance that they wouldn't have to disclose this [lending]. What we have come very close to saying but we haven't said it yet--the specific question was on the prior Mexican debt--is that we would accept [the following] arrangement: That if the Mexican private debtors can get up the pesos and deposit them with the central bank and these banks agree eventually to take it over, if they have to, [we would call that] a new loan to the central bank.

MR. FORD. We'll pretend it's in dollars.

CHAIRMAN VOLCKER. Well, it is in dollars. The loan has always been denominated in dollars. We are saying for the time being, and it's a bit of a stretch, that the dollars [are] in the hands of a central bank as opposed to the companies [and we] will count that loan as being current, provided the banks agree to lend them the money to pay the interest, which is what they are doing with the whole thing. But every one of these countries is being lent money to pay interest. If you went all the way in the other direction, you'd have to say all these loans were nonperforming because they are all borrowing to pay interest. This is a little more direct.

VICE CHAIRMAN SOLOMON. That's true for domestic corporations. If a bank came up with new money for a domestic corporation so it doesn't fall into arrears, that's still considered a performing asset.

MR. PARTEE. It depends on the terms. If the loans are at commercial terms, they would not be nonperforming. But if they are at concessional terms, they would be nonperforming.

VICE CHAIRMAN SOLOMON. Okay. These aren't concessional either.

MR. FORD. I don't want to prolong the discussion, but obviously there is a substantive distinction. To be sure, all debt grows over time as assets grow and nobody ever pays off big loans. That's one argument one could make. But one way to look at is to ask: If these banks could do these loans over again, what would they do? From the phone calls that we've had, these banks would all want to be out tomorrow.

CHAIRMAN VOLCKER. There is no question that this has some flavor of compulsion--I mean internal compulsion--in that the only reason they're making the loans is to make the old loans good, individually. There's no question.

MR. FORD. And the new element is that the IMF is requiring it. Isn't it the first time in history that the IMF is saying: We're not putting up ours unless you put up yours?

MR. TRUMAN. That is a popular and widespread misconception. The IMF has in fact been essentially doing that for several years now, basically because the Fund cannot provide enough money by itself in many cases to cover what--as Governor Teeters was remarking--is a reasonable adjustment program in the first year, especially if allowance is made for a country bank getting out. They will not present a program to the Board which says that there is this big financing gap.

VICE CHAIRMAN SOLOMON. Bill, it's true that it hasn't been as explicit in a certain sense because the need wasn't as much earlier. They used to talk in terms of a cap on foreign borrowing; and even though it's still a cap, now there's a problem of a floor as well. Formally, it's nothing new; but I think the [unintelligible] concern as to the financing is greater funding--

CHAIRMAN VOLCKER. There's no question that these loans are not liquid in a very obvious kind of way. I think it is also true that the loans are better after this than they were before because if this doesn't work, you know you have a pot full [of losses]. The banks not only have illiquid loans, they will have no interest payments. It's not a satisfactory situation by any stretch of the imagination.

MR. WALLICH. The IMF programs have always been on the assumption that they do not finance the country fully but they turn the country around so that it becomes bankable again. Now, what is happening here, as I would interpret it, is that they are pulling that moment somewhat forward rather than waiting a year until the bankability is demonstrated. They ask for the money right away.

MR. PARTEE. They try another way.

MR. CROSS. Well, the Fund got burned in a couple of cases where they financed some programs and it looked as though some of their money was being used to pay off the banks and that made it much worse. So, they've gone further and further along this line of insisting on getting the money there up front.

MR. BOEHNE. Well, the bottom line is: What is the alternative? Let it all go to hell or try to put a package together if we can get them to play ball? And that is what we're doing. What's the alternative to that?

VICE CHAIRMAN SOLOMON. This is a cheaper way of doing it. If everything goes to hell then the amounts of both public assistance and losses to the banking system are going to be [huge]. I can't conceive that the United States would not step in ultimately and do what was necessary to restore order in Mexico to tame the chaotic situation. But the problem may be that political events in a chaotic situation would take over and we might be confronted with a--

CHAIRMAN VOLCKER. I think we'd better get to our policy problem. It has been a long time since Mr. Axilrod introduced it.

MR. FORD. He's been writing diligently.

CHAIRMAN VOLCKER. Let's come to the point, Mr. Axilrod.

MR. AXILROD. Mr. Chairman, I think one helpful comment that could be made would be to explain the two alternative operating paragraphs before the Committee. But before that I should make two comments. One is generated by the Committee's earlier discussion. The staff will go ahead and begin developing a monthly total credit series to see what its statistical properties are and how fast we can get it and how it develops. I would like also just for my own professional peace of mind to go ahead and try to do some econometric work on supply and demand relationships in total credit if we can possibly uncover them, somewhat like what we had tried to do with supply and demand for money. And if we got that far, I think we would be at the frontiers of the economic profession. But we'd like to make that effort. So, we would propose to proceed in that way on the total credit. I don't know how far we'll get before midyear but hopefully fairly far. Another related point on the operational paragraph of the directive, if you turn to lines 55 through 58 on the draft with the numbered lines that was passed out to the Committee--

MR. PARTEE. Alternative one?

MR. AXILROD. Yes. Before that it says: "The Committee also indicated that it was tentatively planning to continue the current ranges for 1983 but that it would review that decision carefully in light of developments over the remainder of 1982." We have some language that might seem more apropos than that since 1982 has only a week-and-a-half to run. We'll have it typed up and given to the Committee, but it reads at the moment: "The Committee had also earlier indicated that it was tentatively planning to continue the current ranges for 1983, but it will review that decision carefully at its February 1983 meeting in light of economic developments and institutional changes associated with the new deposit account authorized by the Depository Institutions Deregulatory Committee." I think that's just a technical holding-in-place. It sounds more apropos than what is in there at the moment. But we'll type that up and send it around.

SPEAKER(?). What line is that Steve?

MR. AXILROD. Lines 55 through 58.

MR. GRAMLEY. The one we have says it's lines 39 to 42.

CHAIRMAN VOLCKER. Yes, I think you have several versions of this thing floating around.

MR. AXILROD. Oh, I'm sorry. It would be the last sentence before the operational paragraphs.

MR. BLACK. Steve, could you read the last part of that again? I got most of it but not--

MR. AXILROD. Well, we're going to type it up and send it around. On the operational paragraphs, alternative one as proposed allows for a high M2 growth, something that would accommodate a shift --if you believe our 3 percentage points--of that order of magnitude. But because that number for M2 would be pretty large--it would have to be, say, 11 or 12 percent really, and that may present some problem of credibility--it would almost seem to call for an early estimate of a shift adjustment factor. That is, if you decided on the 11 or 12 percent but thought two or three or four percentage points of that was shift, once you go that route, then I think it inevitably involves a continuing shift. While that is one reasonable approach, the staff--or certainly I--would tend to prefer the approach of alternative two, which allows for a smaller rate of growth in M2 and also includes an M3 growth that probably, as President Corrigan mentioned, is not going to be as much affected by shifts. So, that's our tentative thinking in this current period.

MR. ROOS. Why do you reject alternative C or three?

MR. AXILROD. I'm talking about directive language, President Roos, alternatives one and two of the directive language. The second alternative allows for a slower rate of growth in M2 and gives an M3 rate of growth and then has language which says growth could be higher --and probably more felicitous language could be developed--if there were substantial evidence of more shifts than had been allowed for in this notional number, based on analysis of incoming data and other evidence from bank and market reports. If the Committee went that way, then after the fact a range or some qualitative indication of the extent of shift might have to be given, but it would not be as committed to a definite shift adjustment. It is really for that particular reason that, in terms of directive language, alternative two might seem somewhat preferable. Of course, no matter which of those alternatives you choose in terms of phrasing the language, the policy issue is more on what level of borrowing the Committee chooses to start, since presumably over the next few weeks there might not be much variation around that level of borrowing unless the behavior of the aggregates is really extreme--unless it becomes clear that the shift distortions may be enough to fuzz up one's analysis of the underlying strength of the aggregates. So, it becomes crucial what level of borrowing is chosen, but it is not insignificant, really, what underlying growth in the aggregates you would tend to want.

CHAIRMAN VOLCKER. I wonder if [this approach] would clarify our discussion. The points that Steve raised are very relevant, but keep in mind what kind of general growth in M2 and M3--I guess in a sense that's what we have to put in the directive--you would want to have without these shift adjustments. Then it's a separate point as to how we make those [adjustments] and how we state them. [We would need to decide] whether we add [shifts] in to begin with or whether we essentially use the directive that Steve is suggesting, which gives a number that allows for little or none but says we may have to allow for [shifts] if they develop. One other point I would make is that on our current projections, which obviously are always subject to change with every bit of [new] weekly data, it looks as though M2 and M3 are coming in lower than the present directive suggests. [Their growth] was higher in November, but if you put November and December together, it looks as if it's coming in below the track that we forecast, which in itself tends to push the borrowing level down a bit. But presumably if that gets confirmed, it would move it down more just on the basis of the existing directive. Now, we reset that at this meeting but if we weren't meeting today and the trend developed as now projected, presumably the borrowing level would be coming down anyway. I think that's correct, isn't it? It would be [down] a little anyway.

MR. AXILROD. Yes, if the balance of December comes out as projected. If it's down about as much as the data through [mid-month suggest] it would be [down more].

CHAIRMAN VOLCKER. You can comment on the basic trend that you would like to see in M2 and M3, what your preferences are, and how to state that in terms of these alternatives and the borrowing level. I think those are the key variables.

MR. BLACK. Mr. Chairman, could I ask Steve one clarifying question on this?

CHAIRMAN VOLCKER. No!

MR. BLACK. Could I slip him a note? Steve, on this second alternative, suppose we settle on "B." Would you put in there for M2 11 percent or 8 percent?

MR. AXILROD. The second alternative is designed as somewhat of a compromise; I think it would be somewhere in the 9 to 10 percent range. You could even continue with the 9-1/2 percent you now have. That would accommodate some shift--

CHAIRMAN VOLCKER. As I see it, just to make it clean, alternative two wouldn't allow for much shift.

MR. AXILROD. No, some.

CHAIRMAN VOLCKER. You're saying "some." Very little to none, I guess, just to keep the choices cleaner.

MR. AXILROD. Yes.

CHAIRMAN VOLCKER. You've allowed for what--a 3 percentage point shift in the aggregates?

MR. AXILROD. Yes, we think--and it's just our guess--that 8 percent is not an unreasonable number without any shifts. This numerology is all based on estimates.

MR. PARTEE. You have absolutely no current information that I can see, including the flash report on the GNP, that indicates that velocity is turning around. It is still going down fast for M2.

MR. FORD. Nothing but the history of every other recovery we've ever had.

MR. PARTEE. But we haven't got a recovery.

MR. CORRIGAN. We haven't got a recovery yet.

MR. FORD. Whenever you wait until the recovery is obvious, you wait too long.

MR. PARTEE. No, I don't think that's true now.

MR. AXILROD. We still have a negative velocity [growth projected for] the first quarter, Governor Partee, but it is a lot less negative velocity [growth] than we had earlier.

MR. GUFFEY. Steve, may I follow up on Bob's question? You were talking about 8 percent as the basic growth for M2 and you are looking at 9-1/2 or perhaps 9-1/2 to 10 percent to go into the directive. And you're thinking of a 3 percentage point shift. Those numbers don't work out.

MR. AXILROD. Well, that's why with the language of alternative two--if the Committee did put in something like M3 growth of 8 percent and M2 growth of 9-1/2 percent, say, and then it turned out that M2 was stronger because of evidence of shifts but M3 was on target, one would assume--depending on the Committee discussion--that we would just accommodate that because that's what the directive would literally say. And one would hope that the moderation of M3 would be an obvious counterfoil to the somewhat stronger M2.

CHAIRMAN VOLCKER. I think in your alternatives here, which I have not explored with great care, you are not allowing for much, if any, shift in M3.

MR. AXILROD. None. Well, there's a little maybe.

CHAIRMAN VOLCKER. So, presumably that is the kind of figure we would put in for M3. And you are saying putting in a number a percent or so higher would allow for just a little shift, which we'd have to explain in the text somehow.

MR. AXILROD. That's right.

CHAIRMAN VOLCKER. Maybe in the directive itself we should make some allusion to the fact that we've allowed a little [for shifts].

MR. AXILROD. We're basically assuming that bank credit demands are not going to be very strong in the first quarter. And, therefore, if the banks get more money in through these money market accounts, they will not be pressing in the market as much and there might even be some direct movement of CDs into these accounts. So, it's a combination of both. That's what we're assuming.

VICE CHAIRMAN SOLOMON. Putting the shift issue aside for the moment, how much of a negative growth in velocity of circulation are you assuming for the first quarter? What is your figure for nominal GNP growth for the first quarter?

MR. AXILROD. It's 6-1/2 percent, I think. And for M2 on a quarterly average basis, which is different from the December-to-March growth, I have 9.8 percent here. But I have to take something between 2 and 3 percentage points off of it, so it's more like between 7 and 8 percent. So it's a minor negative velocity growth of something like 1 percent, let's say, as against the sharp negative velocity growth of something like 5-1/2 percent over the year.

CHAIRMAN VOLCKER. Let me get clear on this. You have a quarterly average of 7 to 8 percent with what from December--?

MR. AXILROD. Well, abstracting from shifts, about 8 percent.

VICE CHAIRMAN SOLOMON. How do you break down that nominal GNP figure in the first quarter? How much is inflation and how much is real?

MR. KICHLINE. In the first quarter, it's 2 percent real and 4-1/2 percent inflation.

CHAIRMAN VOLCKER. Mr. Balles, you had a question before.

MR. BALLES. Well, I think my clarifying question has been asked twice now. I gather that the alternatives set forth in the Bluebook on page 6 would be consistent only with alternative one of the directive, which you don't prefer.

MR. AXILROD. There are differing numbers in those alternatives. I'm suggesting that you might use alternative two, which incorporates the lower numbers that do not fully allow for the shifts. If you use the M3 numbers that are there but subtract 2 to 3 percentage points from the M1 number, you would not be making as much advance allowance for the shifts as is in the text, which is our best estimate of the shifts. However, the shifts may not occur.

MR. BALLES. You said M1; did you mean M2?

MR. AXILROD. I'm sorry, I meant M2--I meant M3 actually. We used the numbers for M3, but we reduced M2.

MR. PARTEE. Those you think are pretty good?

MR. AXILROD. Yes.

MR. PARTEE. For the M3 numbers.

MR. BALLES. Just to nail that down once more, how many points off the M2 numbers in the Bluebook?

SPEAKER(?). Three.

MR. AXILROD. To get a sense of the underlying demand, for whatever that's worth, you take 3 points off. But I would suggest putting a somewhat higher number than 8 percent. If you took 3 points off the 11 percent for "B," you'd get 8 percent because it seems to me it would be reasonable to allow for some shifts. And the Committee already has 9-1/2 percent for M2 on the record for October to December. And that would seem like a continuance of that; that would be just one compromise between the two.

MR. BALLES. Okay. Thanks.

MR. CORRIGAN. Peter, where do you and the market think borrowings are these days?

MR. STERNLIGHT. Well, I may have to give you two different answers for that. We've been aiming at around $250 million or a little below; it's been $230 million in the recent weeks. A number of recent weeks have tended to come out above that because of exigencies--some shortfalls of reserve projections or greater demands for excess. In the current week borrowing is averaging around $300 million. As for where the market thinks it is now, they probably would just take an average of the recent weeks, which would be between about $250 million and [$350] million.

CHAIRMAN VOLCKER. We always talk in shorthand about this borrowing level, which is very convenient, but it seldom comes out there because what we're really doing is setting a reserve path. If excess reserves are high, the borrowings are high. And we're entering a period, the year-end period, where the excess reserves may be very erratic. So as shorthand for setting a reserve path maybe [we should talk about] a free reserves number rather than an actual borrowing number, particularly when excess reserves are going to be volatile at the end of the year.

MR. WALLICH. It's the reserve path that decides--

CHAIRMAN VOLCKER. That's right. We're just setting the beginning point of a reserve path. Well, in the absence of anybody else talking, let me say this: Simply because these other numbers are so big and we have to give an explicit estimate of a shift adjustment we don't know anything about, I like the alternative two approach. I don't know how much to allow for, but I'd allow for some shift; if we're allowing for some, we have to be very clear either in the directive or the text that this is a higher number than we would have put down except that we are assuming some minimal amount of shift.

MS. TEETERS. Well, if we just put in 9-1/2 percent and leave the borrowings there, does this language in alternative one say that if it actually comes in around, say, 11 percent, that we would tolerate it? That's the way I'm reading it.

MR. AXILROD. It's the language in alternative two. I was getting some better language [typed up]; I had hoped it would be done. Yes, the language would imply that if there were evidence from incoming data and reports from the market and from depository institutions that there was a shift--and I added in brackets if underlying demands for liquidity were exceptional, if the Committee wants to say that--[stronger growth would be tolerated]. So, there would be plenty of scope in the directive to allow for stronger growth.

CHAIRMAN VOLCKER. But what it says is that our first bit of evidence would be if [M2] came in high but [M3] did not; then we would be more inclined to think it was a shift than reality. If they both came in high, we would tend to discount the very first--

MR. AXILROD. Unless we found some evidence of a huge shift.

CHAIRMAN VOLCKER. Unless there were other strong evidence.

MR. WALLICH. Building the shift into the number in alternative two seems to me to take away some of the virtue of alternative two, which is that it allows for what we think ought to be the right number but then allows for an overrun in case [a shift occurs]. It seems to me that is in many ways preferable. But if we also raise the number, then we've taken the high number from alternative one and we still have the overrun of alternative two.

VICE CHAIRMAN SOLOMON. I agree. I think alternative two is clearly preferable. It would seem to me that we're still allowing not only for a one percent shift but also for one to two points negative velocity [growth] if we accept that 9-1/2 percent figure. We could say 9 to 10 percent or we could put in 9-1/2 percent like we did last time. But the initial borrowing assumption ought to be $175 to $200 million because I think we would like to see the markets ease a little on their own and not be pushed down so obviously and aggressively by a cut in the discount rate. If [the Board] does end up cutting the discount rate, we again would appear to be following the markets somewhat more. So I would think we can leave the fed funds range where it is, at 6 to 10 percent.

CHAIRMAN VOLCKER. Just for the sake of completeness, what do you have for M3?

VICE CHAIRMAN SOLOMON. 8 percent.

MR. GRAMLEY. What is your M2 number, Tony?

VICE CHAIRMAN SOLOMON. M2 would be 9-1/2 percent, assuming we're going the alternative two route.

CHAIRMAN VOLCKER. And assuming we say someplace that we are allowing for a little shift.

VICE CHAIRMAN SOLOMON. I don't know what the adjectives should be, but alternative two would read--

MR. GRAMLEY. Is this supposed to be a shift-adjusted number now?

VICE CHAIRMAN SOLOMON ET AL. No.

MR. GRAMLEY. The whole idea of alternative one was to put in a number that had no shift adjustment. I thought alternative two was to be an alternative in which we had a shift-adjusted number.

SPEAKER(?). No.

MR. PARTEE and MS. TEETERS. They're not big enough.

MR. GRAMLEY. That isn't the way it reads. The way it--

CHAIRMAN VOLCKER. In the Axilrod version, it is a conservative estimate of a shift.

MR. PARTEE. For alternative two.

CHAIRMAN VOLCKER. For alternative two.

MR. PARTEE. I think so, too; 9-1/2 percent doesn't sound high enough.

MR. GRAMLEY. If these estimates are right, 9-1/2 percent implies a 6-1/2 percent shift-adjusted M2 growth. And that's ridiculous.

VICE CHAIRMAN SOLOMON. No, wait a second. The actual language of alternative two reads: "The Committee indicated that greater growth would be acceptable if there is evidence of substantial shifts of funds into broader aggregates because of the new money market account."

MR. GRAMLEY. What kind of a path is he going to draw from this?

MR. AXILROD. Well, if the Committee wanted 9-1/2 percent and 8 percent, I would take our M1 estimate based on that, which is pretty high--something like 8 percent--and draw a path based on the related required reserves. But that wouldn't affect the money market if M2 were coming in strong because with the virtues of lagged reserve accounting we would know the required reserves two weeks later and we would simply accommodate to it.

CHAIRMAN VOLCKER. If you thought there was a shift?

MR. AXILROD. That's right. If there were shifts and M2 were strong.

MR. PARTEE. Shouldn't that say "greater growth in M2 would be acceptable"?

VICE CHAIRMAN SOLOMON. Right.

MR. PARTEE. It doesn't say that.

VICE CHAIRMAN SOLOMON. Oh, I see. Yes, I think that would be a help.

MR. BLACK. That's about what it says, as I read it.

MR. BALLES. At the risk of muddying the waters, Steve: Would there be any virtue in an alternative that abstracted altogether from shifts and then left us with an option of adjusting for it ad hoc as we got the evidence?

MR. AXILROD. Well, that's what this in effect does. I think the issue is only whether you put down 8 percent, if that's what your underlying preference is, or whether you put down a number that's a little higher so you give some notional sense that shifts may occur. Thus far, that is what the issue seems to be.

VICE CHAIRMAN SOLOMON. Also, the reason why we would want 9-1/2 percent without shifts is because we don't think velocity [growth] in the first quarter is going to go back to zero, which is an historic norm.

MR. GRAMLEY. Now you're talking about this as a not shift-adjusted number.

VICE CHAIRMAN SOLOMON. I'm talking about 9-1/2 percent and that we would tolerate a modest amount of growth beyond that if there were evidence of substantial shifts.

MR. GRAMLEY. But we're already expecting 3 percentage points.

VICE CHAIRMAN SOLOMON. Yes, but that's 3 percent at an annual rate.

MR. GRAMLEY. I know. But if we're talking about 9-1/2 percent as a not shift-adjusted number, that implies about 6-1/2 percent shift-adjusted and if we have velocity declining in--

CHAIRMAN VOLCKER. It's the other way around.

MR. BLACK. It's the other way around, Lyle. And this is a hybrid anyway; it has 1-1/2 [percentage points] in shift adjustment not taken out.

MR. GRAMLEY. I'm thoroughly confused.

CHAIRMAN VOLCKER. I don't know quite what Tony has in mind. In the Axilrod version, just putting in Tony's number, he is saying that allows for one percent or so of shift adjustment, which we think is minimum. It's the equivalent of saying between "A" and "B" on the other numbers. If you were really right that the shift was 3 percent, who knows?

MR. FORD. That doesn't square with table 4, does it?

MR. PARTEE. Where's table 4?

MR. FORD. Page 11 of the Bluebook. If I read this Bluebook summary of your estimate of the shifts right, it says that for the December-to-March period we're talking about you think the shift in M2 could be as little as 1 percent and could be as much as 5 percent. Oh, you're getting 3 percent by averaging.

MR. AXILROD. No.

MR. STERNLIGHT. It's 1 percent for the year, but 3 percent because they expect a lot of it to be concentrated in the first quarter.

MR. AXILROD. For the December-to-March period our best estimate was one to five. I would like to make clear to the

Committee--we tried to say how we got to that estimate--that the range of uncertainty here is really vast, though the numbers weren't quite off the wall, as Governor Gramley suggested. All I'm suggesting is that the Committee put in the directive a number with which it feels generally comfortable; and if it turns out to be bigger, then the market would tighten if there are no shifts; and if there seemed to be shifts--

CHAIRMAN VOLCKER. I will return to my interpretation for the purposes of clarity. We can do it differently, but let's get some common basis here. I'm won't say this is what Tony said; I'll say it's what I'm saying now. We can put in a 9 to 10 percent figure, for instance, or 9-1/2 percent just to make the arithmetic correct, and say someplace--probably right in the directive--that we are allowing for a modest increase in M2 from a normal trend because we think there is going to be some minimal amount of shifting. In fact, we are prepared to see a bigger shift, in accordance with the staff estimate. If the evidence develops that way and the staff is right about the 3 percent, the 9-1/2 percent is equivalent to 11-1/2 percent. In fact, nobody is going to know with any precision if it is in the end. But analytically that's what I would suggest we are saying. In other words, 9-1/2 percent is equivalent, without allowing for any shifting, to 8-1/2 percent.

MR. BALLES. I think that clarification would take care of the problem I was worrying about, Mr. Chairman.

MR. WALLICH. I would prefer the 8-1/2 or 8 percent for that reason. It keeps separate the original unadjusted number and the shift.

CHAIRMAN VOLCKER. Well, I can understand that. But it's just a matter of preference. You would be putting down a number which the staff at least thinks is too small. And we will never make it.

MR. MARTIN. Yes, we'll never be able to make it.

CHAIRMAN VOLCKER. And that has its difficulties, too. My sense of the this is that if we're allowing for any shift here, we probably ought to say it right in the directive. We could say in the next sentence that this number for M2 allows for some exceptional increase in M2 because of this switching. If there's more than this little we allowed for--we keep the [suggested] sentence that's there.

VICE CHAIRMAN SOLOMON. The 8-1/2 percent then permits a negative velocity [growth] of 2.

CHAIRMAN VOLCKER. Yes, if the GNP number is right.

VICE CHAIRMAN SOLOMON. Well, I was not very clear about that. By suggesting that 9 to 10 percent or 9-1/2 percent, I was fuzzing together the negative velocity [growth] and the minimal shift; and then if there were a substantial shift, M2 growth would be above that.

CHAIRMAN VOLCKER. Well, you are right where I described it, I guess. There seems to be some general feeling that we ought to work with alternative two. Can I assume that?

MR. GRAMLEY. I was thinking of going the other way. My thought was that we need to include in the directive a number that is realistic and also has some indication of shifting. I think the alternative two as you now propose it is alternative one prime; it is no longer alternative two as it was in the Bluebook. I would prefer to use a number like 11-1/2 percent and say that it includes an amount of shift ranging from one to five percentage points. I want to emphasize the uncertainty. The 11-1/2 percent comes from the same shift-adjusted 8-1/2 percent we started with.

CHAIRMAN VOLCKER. I don't think we can put in a number in [alternative] one and say this allows for a shift ranging from one to five percentage points; we would have to put in a range of 3 or 4 points around the number. We would have to say we are aiming at 9 to 13 percent or something to allow for a shift of one to five points. I'm not sure that helps.

VICE CHAIRMAN SOLOMON. It's awfully dangerous to be that explicit on the estimate of the shift.

CHAIRMAN VOLCKER. The argument against alternative one, as nearly as I can understand, is composed of two related arguments. We haven't the vaguest idea, really, what the shift is going to be. If we just put in a visibly high number, not knowing what the shift is going to be, we may get a psychological problem, which we don't need to be read into this right now.

MR. GRAMLEY. Maybe.

MR. PARTEE. We carried 9-1/2 percent this last time.

CHAIRMAN VOLCKER. Yes. Let me ask my question over again. You responded. I don't know whether you're convinced or not. Do we work with directive two? Okay, that seems to be [the consensus]; let's work with directive two. Let me repeat the proposal we have on the table. Whether or not it's exactly Tony's--and I think it comes close--we put in either 9 to 10 percent or 9-1/2 percent, which happens to be the same number we've been working with and 8 percent [for M3], as I understand it. We say explicitly--Steve just gave me some language: "Allowing for some shifting into broader aggregates, particularly M2, resulting from the introduction of the new money market accounts." So, we've explicitly said that 9-1/2 percent allows for some and then we keep something like the next sentence that is already there.

MR. GRAMLEY. Could we say "a modest shift"?

MS. TEETERS. We don't know if it's going to be modest.

CHAIRMAN VOLCKER. But in this first sentence we said [unintelligible] allowing for modest shifting or something.

MR. GRAMLEY. I want to protect against the possibility that we may have to allow M2 to grow by 14 or 16 percent or some number like that.

MR. AXILROD. [That would be covered in] the next sentence.

MS. TEETERS. The next sentence says that.

VICE CHAIRMAN SOLOMON. I think we might even be justified in calling it a minimal shifting.

MR. GRAMLEY. "Allows for a modest amount of shifting."

CHAIRMAN VOLCKER. Well, let's see: "allowing for modest shifting" or "some shifting."

MR. PARTEE. "From market instruments." We're not talking from M1 up to M2.

VICE CHAIRMAN SOLOMON. From market instruments and large CDs.

MR. CORRIGAN. That's why I think that sentence has to be limited to M2.

VICE CHAIRMAN SOLOMON. Right, it should be limited to M2.

CHAIRMAN VOLCKER. All right, we'll say "allowing for some shifting into M2," if that's the way you want it. This states it the other way around, resulting from the introduction of the new money market accounts. It doesn't say from where but it says--

MS. TEETERS. Then the phrase about M3 should come down to the bottom so that all of this obviously applies to [M2].

CHAIRMAN VOLCKER. I think if we say M2, it's clear enough. "Allowing in the case of M2 some..."

MR. AXILROD. Well, there could be a bit in M3. Maybe it's a mild degree of perfectionism--just guarding against all possibilities. It's not clear that they are going to offset.

MR. PARTEE. Except that as a bank funding device it seems to me that it will tend to offset.

MR. AXILROD. Yes.

MR. PARTEE. [Unintelligible] unexpected bank influence on M2 because they aren't going to have any credit demand and they're not going to want to extend credit anyhow.

MR. AXILROD. But there are the thrifts, Governor Partee. I don't know what they're--

MR. PARTEE. Well, they don't have any credit demand either.

CHAIRMAN VOLCKER. We can come back to the precise language. The proposal on the table is 9-1/2 percent, which implicitly allows--I will say--for 1 percent of this shifting in M2 and for zero shifting in M3 with a figure of 8 percent. Tony said about $175 to $200 million for the initial borrowing figure.

MR. PARTEE. That's down some.

MR. RICE. It may be a little low.

VICE CHAIRMAN SOLOMON. That's down from about $230 million. To get some perspective on what that means, I'm told that a 1 percent difference in the target for M2 would mean over a period of one month a difference of $34 million dollars in reserves. Therefore, if we are moving the borrowing from, say, $230 million to a shade under $200 million, it's the equivalent of having a 1 percentage point higher M2 target for one month. So, I would say that at the maximum we ought to set it at $200 million but we might go as low as $175 million.

MR. BOEHNE. And what does it mean for the funds rate?

VICE CHAIRMAN SOLOMON. Well, it would be somewhat under 8-1/2 percent; how much under, Peter can make a better guess than I.

MR. STERNLIGHT. Well, varying around 8-1/2 percent, but maybe a little more likely to be under than over.

MR. BOEHNE. Under 8 percent?

MR. STERNLIGHT. Under the 8-1/2 percent discount rate.

MS. TEETERS. Under 8-1/2 percent. Borrowing of $175 million would take it down toward 8 percent, wouldn't it?

MR. STERNLIGHT. Not that far, Governor. I think with $175 million it would be more likely to vary under the discount rate, between 8 and 8-1/2 percent, but not necessarily closer to 8 percent than to 8-1/2 percent.

MR. WALLICH. Do you figure $100 million [in borrowing] is equal to 25 basis points [on the funds rate]?

MR. STERNLIGHT. Roughly, yes. That falls out of these time-honored relationships, but they don't necessarily hold up in the short run.

CHAIRMAN VOLCKER. It's not very reliable from week to week, and the funds rate will be affected by whether people think the discount rate is coming down or whether the economy is improving and the rate decline is over or whatever.

MR. GUFFEY. At this level aren't we at or below the frictional level [of borrowing]? As a result wouldn't we have lost the advantage of the path and what it might imply?

MR. AXILROD. Between $175 and $200 million used to strike me as quite frictional; [now] I would think we would be getting below that level when we get down to $50 million or so. I would agree thoroughly with Peter that unless there's a big expectation of a discount rate drop, the funds rate would tend to hang around the present discount rate and would be a little more likely than it is now to be below it. It isn't below it now; it has been running above it except for today.

MR. GUFFEY. With the level of excess reserves that the banks want to hold, if that continues, this has some implication it seems to me for the federal funds rate in the period ahead. Is that right?

MR. AXILROD. Yes, the funds rate would go up if we underestimate the demand for excess reserves. We would, of course, make every effort not to; we have models that turn out not to be too bad, in fact. Sometimes they have been better than our judgment on that. So, we have a fairly good way of trying to estimate the demand for excess reserves. And Peter makes his own estimate over the course of the week if he sees that it isn't working out right.

MR. PARTEE. We have a number of pretty sick banks. If we were to have some unexpected borrowing at the window by those sick banks, you would not count that as adjustment borrowing?

MR. STERNLIGHT. Where it's a big identifiable borrowing, we make an allowance for that.

MR. AXILROD. Certainly if it's over a sustained period, it would be [counted with] nonborrowed reserves. If it's a bank that just happens to be at the end of the queue and comes in for a day and is out, that strikes me as adjustment borrowing. But if a bank is in for a sustained period, then it's more clearly nonborrowed.

MR. PARTEE. Of course, they tend to be at the end of the queue because they are generally regarded as weak banks.

MR. AXILROD. That's right. But if, for example, Continental is in one day and then out and it just happened that the borrowing fell on Continental, as it would naturally--

MR. PARTEE. I was thinking more of, say, some of these banks who at least partially lost their access to the Euro-markets. They might have to come back in for a rather substantial loan.

CHAIRMAN VOLCKER. Well, it's easier at that point to adjust for it, but in the initial stages it's likely to be hazy.

MR. PARTEE. Yes. I see.

MS. TEETERS. Mr. Chairman, I can accept Tony's formulation of this. I would guess we ought to go to $175 million [rather than] $200 million, but I don't think it makes a lot of difference. I also find myself a little [uneasy], given the length of time until the next meeting and all these uncertainties. I'm not necessarily suggesting a full blown FOMC meeting, but I think it would very wise if a couple weeks into January we at least got updated on where we were.

CHAIRMAN VOLCKER. I think that is correct, and I would plan to do that.

MS. TEETERS. I can live with this for three or four weeks subject to a re-evaluation at that time.

MR. WALLICH. What would be the evaluation of the market if they could perceive this correctly? Is this somewhat similar to the latest discount rate action?

MR. RICE. I think it's close, but it preserves the status quo.

MR. WALLICH. Well, that is what I'm asking. Is it that or will it be seen as another push and does it run the risk of being counterproductive at the long end?

VICE CHAIRMAN SOLOMON. If M2 and M3 growth are as weak in December as Steve is projecting, then I don't think this will be perceived as an aggressive push.

CHAIRMAN VOLCKER. Technically, I think it's slightly tighter than the last directive if one literally--

MR. CORRIGAN(?). That's right.

VICE CHAIRMAN SOLOMON. What would bother me in terms of the markets--and I think [the likelihood] is not great--would be if the growth doesn't come in that weak so we do get some natural decline in the fed fund rates. If the fed funds rate stays around 8-1/2 percent and then the Board simply aggressively cuts the discount rate 1/2 point without there having been any softening in the fed funds market, that would give a very strong impression of aggressiveness. That has both positive and negative aspects to it but I think more negative. If we go somewhere along these lines, what we're saying is that unless the weakness develops in M2 and M3 in December, the fed funds rate will tend to stay more or less where it is.

MR. PARTEE. It's pretty much a status quo.

VICE CHAIRMAN SOLOMON. That's what we're saying if we adopt this set of numbers. If there is weakness, then the fed funds rate will probably go lower and the Board may or may not choose to ratify that with a discount rate cut.

CHAIRMAN VOLCKER. Comments?

MR. GRAMLEY. It sounds all right to me.

MR. RICE. I agree with this proposal.

MR. PARTEE. I'm a little nervous about M2. I don't think M2 bears any relationship to anything. I don't think it's off the wall any more--a number that somebody conceived of. But it doesn't seem very [unintelligible] by itself. I guess I would accept this.

MR. BLACK. Despite all this discussion of what the aggregates might do and despite my strong predilection toward targeting aggregates, I don't think we have much choice other than to target interest rates in the short run.

MR. PARTEE. And that's what this is doing.

MR. BOEHNE. Carrying that tattered fig leaf for one more--

MR. BLACK. But I must say that my feeling about what are the appropriate rates is conditioned by four months of what I think has been very excessive growth in M1. I don't pretend to know what caused all that; it may have been precautionary demands for money. But every time the federal funds rate has come down by 6 points or so, as it has over the period since June, we've had a spurt in the aggregates. And I think that drop in the federal funds rate must have played a pretty significant role in itself. I'm very reluctant to go lower on the federal funds rate than we are now. I would want a floor, a lower limit of 8 percent on it. If the aggregates come in weak, I would not mind the rate coming down to 8 percent, but I'm very leery about going beyond that.

CHAIRMAN VOLCKER. The assumption, implicitly, is that the federal funds range in the directive stays at 6 to 10 percent. I don't see any particular reason to change that, as Tony suggested.

MR. BOEHNE. I'm not voting but if I were, I would support the formulation that Tony and Nancy and others have subscribed to. There is one point: If the judgment of the Board is to lower the discount rate, to ratify this, I think it would be better perceived if we could see a little more progress on the funds rate toward 8 percent before a discount rate change came along. That's in keeping with the idea of having a mid-January meeting because if the funds rate could drop and then the discount rate followed it, I think that would be digested better than the other way. The other way looks a bit too much like pushing and raises the risk of a perverse effect in the long-term bond market.

CHAIRMAN VOLCKER. I see. We can all say we're targeting interest rates and all this is a meaningless exercise, but in fact we are targeting a reserve path which has some influence on the funds rate. If the aggregates are not coming in at a level which justifies moving the funds rate lower at that point, under these directives we can't do it.

MR. CORRIGAN. I have no problems with this formulation. I think it's fine.

VICE CHAIRMAN SOLOMON. What happens, Steve, if M2 and M3 come in so weak and the demand for reserves is so low that there is virtually no borrowing and we start getting an indeterminate fed funds rate? What will we do at that point?

SPEAKER(?). That's exactly the--

VICE CHAIRMAN SOLOMON. I don't think that should stop us from going down now to the $175 to $200 million area.

MR. AXILROD. We would certainly alert the Chairman if that were--

CHAIRMAN VOLCKER. I don't think the funds rate is going to become all that indeterminate all that soon. But at some point we might want to reduce the discount rate and tighten up on the reserve path.

MR. PARTEE. It's hard to imagine that for M2 in particular. How could it be that weak?

VICE CHAIRMAN SOLOMON. Steve is talking about 4 percent growth in December and it's possible, though not too likely.

MR. BLACK. Did you say it was revised up to 6 percent?

MR. AXILROD. No, I was just muttering [about how we might] find an [unintelligible] range.

MR. CORRIGAN. You're not supposed to do that, Steve!

MR. BLACK. We might have to go through this again, Steve.

CHAIRMAN VOLCKER. I don't want to rush you here, but I don't hear any contrary views. Is there a preference between expressing it as 9 to 10 percent or 9-1/2 percent in the first place? I hear 9-1/2 percent. And 8 percent for M3?

MR. GUFFEY. Mr. Chairman, I'd like to raise a question about 8 percent for M3, given the performance of M3 over the past two quarters and what is estimated in the first 2 months of the fourth quarter. It isn't clear why 8 percent is a magic number for M3. It looks to me as if it may be somewhat restrictive.

MR. AXILROD. M3 has been slowing down very recently and we were influenced in good part by that, of course. But for the year it has been--

MR. GUFFEY. For the year and for October-November it is over 9 percent.

MR. AXILROD. Yes. We have estimated a very weak December coming up. Whether or not that will develop, [I don't know]. This is somewhat stronger than we think the average of the three months--

MR. GUFFEY. So, you're anticipating that that trend will continue for the next 3 months. I don't understand on what basis you make that projection.

MR. AXILROD. We go through the various components and then make some estimate of credit growth at banks and how they might finance that, given what we think of the others. And this is what comes out in a sense.

VICE CHAIRMAN SOLOMON. The banks are cutting back very strongly on large CDs, Roger, as they get money in the money market accounts, particularly since credit demands are weak. That's a very substantial cutback we are beginning to see.

MR. AXILROD. If there were a considerable expansion in bank credit growth, this number could well be higher. Or if there were a big switch and banks decided to finance through borrowing here rather than abroad, that could affect this. We have not allowed for that; we have allowed for a generally weak economy and still some--

MR. GUFFEY. There's a real possibility that bank credit will grow simply because of these new money market funds. Funds are being attracted at 10 percent. They don't have any loan demand; they are going to have to put those funds to work in some way.

MR. CORRIGAN. They will go make some more lousy loans!

MR. GUFFEY. That's right. They're going to have to make some loans because the only rate that can give them any spread is either on commercial or consumer loans.

MR. PARTEE. They can use the money to pay down their CDs.

MR. AXILROD. Pay down CDs. If that doesn't happen--

MR. FORD. The borrowing assumption in this package is $175 to $200 million?

CHAIRMAN VOLCKER. Well, we have to decide upon that. Let's just take the numbers [for the aggregates] first and come to the borrowing assumption later. The numbers proposed are 9-1/2 and 8 percent. I suggest language for the rest of the sentence saying "allowing in the case of M2 for modest shifting into the new money market accounts from CDs or market instruments."

MR. CORRIGAN. Large CDs.

MR. PARTEE. Yes, large CDs. That sounds fine.

CHAIRMAN VOLCKER. All right. Is that sentence agreeable? Then we go on with another sentence--just to complete the directive and we will get back to the borrowing. Did you have new language for the directive?

MR. AXILROD. I think you have it right there. It's what I gave you as the new language. It is just typed funny.

CHAIRMAN VOLCKER. What did you give me? It's this page I've been writing on? Okay. "The Committee indicated that greater growth would be acceptable if analysis of incoming data and other evidence from bank and market reports indicate that the new money market accounts are generating more substantial shifts of funds into broader aggregates from market instruments."

MR. CORRIGAN. Should that be just M2 there, too?

MS. TEETERS. No, that covers M3.

CHAIRMAN VOLCKER. This covers both as written.

VICE CHAIRMAN SOLOMON. Well, I have a preference--since the amount of shifting to M3 is going to be small--not to have our hands tied by having to have evidence that the shift is occurring in M3 as well. It would seem to me that there's some advantage in having even that sentence refer to M2.

MR. GRAMLEY. It doesn't say M2 or M3; it's general.

MR. VOLCKER. No.

MR. GRAMLEY. We can interpret [the evidence]; that gives us flexibility to--

VICE CHAIRMAN SOLOMON. It sounded to me as if--

CHAIRMAN VOLCKER. No, I think it clearly gives us flexibility. Is that okay? There was a bracketed portion in the original draft reading "or signs of exceptional liquidity demands." Do you want to leave that in or out?

MR. RICE. In.

VICE CHAIRMAN SOLOMON. We have so many qualifications.

MR. BOEHNE. It's just another way of saying we can't predict velocity. It seems to me a very honest thing to put in there.

CHAIRMAN VOLCKER. I'm not going to bleed and die one way or the other on this one. I don't know whether that on balance is good or bad. Let's have a show of hands just from the voting members on this portion of the sentence--a referral to if there are exceptional underlying liquidity demands.

MR. BLACK. Is this for leaving it in or taking it out?

CHAIRMAN VOLCKER. Let's make it for leaving it in, in the first instance. It looks as if we have a minority of members who prefer that. Let's leave it out for the moment.

MS. TEETERS. Maybe you should poll for taking it out?

CHAIRMAN VOLCKER. It's going to rest upon the strength of one's conviction, I guess. Comments about taking it out?

VICE CHAIRMAN SOLOMON. Yes, I'm in favor of taking it out.

MR. GRAMLEY. I would take it out also.

CHAIRMAN VOLCKER. We have more for taking it out. And we have 6 to 10 percent on the federal funds rate range. All right, that takes care of the directive language. We're left with the borrowing. Let me just try out $175 million as one end of the range that was suggested. Who prefers that? Four. Who prefers $200 million? There may be other numbers. Five.

VICE CHAIRMAN SOLOMON. $187.5 million!

CHAIRMAN VOLCKER. The answer is $187.5 million. Let me suggest that we use $200 million, but in these great decisions we make from day-to-day that we make them on the side of being a little below rather than a little above. Is that acceptable? I guess we have done the whole thing. Well, we have that language that you were talking about at the end of the previous paragraph.

MR. AXILROD. Yes. We have it; it could be distributed.

MR. BLACK. I would like to have a copy because I can't get the words down as fast as they pour out.

MR. AXILROD. Norm is distributing it. I'm sorry about these various forms in which the [draft] directive is being provided. The relevant language is in lines 55 to 58.

CHAIRMAN VOLCKER. It's very important because this will only be released after we've already done it.

MR. FORD. If all goes well.

VICE CHAIRMAN SOLOMON. What does this sentence achieve particularly, Steve? It just shows that we were talking here privately but haven't talked any more about the long-term ranges?

CHAIRMAN VOLCKER. It's pointing out that we will review the decision carefully in the light of developments over the remainder of the year. Literally it says our decision is going to be affected by what happens in the next week and a half and that looks a little odd.

VICE CHAIRMAN SOLOMON. I agree it does.

MR. AXILROD. That's all I had in mind.

CHAIRMAN VOLCKER. I think it's trivial.

MR. AXILROD. Yes, no one would pay much attention one way or the other.

VICE CHAIRMAN SOLOMON. We could delete the whole sentence in this earlier form or in its new form. I don't know what it adds.

MR. PARTEE. Well, I don't know.

MR. ALTMANN. Well, it has a reference to 1983.

MR. PARTEE. To delete the sentence tends to delete the reference to 1983.

CHAIRMAN VOLCKER. It's a sacred piece of boilerplate. I really think it has no significance whatsoever.

MR. AXILROD. That's right. I didn't think so either.

CHAIRMAN VOLCKER. Governor Gramley suggests that the first sentence in the whole directive should be changed.

MR. GRAMLEY. I don't like to say final sales strengthened when they went up about a tenth of one percent.

CHAIRMAN VOLCKER. He is suggesting: "Real GNP declined in the fourth quarter, although final sales apparently were roughly unchanged" or "were maintained."

MR. PARTEE. There was a very small percentage increase.

CHAIRMAN VOLCKER. I think we can accept that change. I guess we are ready to vote.

MR. ALTMANN.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
President Balles	Yes
President Black	No
President Ford	No
Governor Gramley	Yes
President Horn	Yes
Governor Martin	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Teeters	Yes
Governor Wallich	Yes

Ten for, two against.

CHAIRMAN VOLCKER. Okay. Do we have anything else?

MR. ALTMANN. Just the luncheon and, on the agenda, the next meeting date.

CHAIRMAN VOLCKER. We ought to think in terms of the possibility of a meeting after the 8th and 9th. We will have at least a telephone consultation sometime in the middle of January.

MR. FORD. Could we pick a date tentatively today?

CHAIRMAN VOLCKER. Well, I don't know whether it's useful right now because I don't have my calendar here nor do other people. We will send something around. Okay, I guess we can eat.

END OF MEETING